

## **Insider Trading by Members of Creditors' Committees - Actionable!**

Mark J. Krudys

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# INSIDER TRADING BY MEMBERS OF CREDITORS' COMMITTEES — ACTIONABLE!

Mark J. Krudys\*

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## INTRODUCTION

Official and unofficial creditors' committees, formed to protect the interests of creditors in connection with workouts and reorganizations, typically receive confidential information<sup>1</sup> such as internal financial statements and projections, as well as information concerning claims against the company. Creditors' committee members are also well positioned to gauge management's reaction to restructuring alternatives and wield significant influence in determining if and when a company's reorganization plan is confirmed by the bankruptcy court.<sup>2</sup> Thus, members of creditors' committees have access to confidential information concerning the uncertainty and length of the workout and reorganization process. This uncertainty causes the securities of the distressed companies to trade at deep discounts. Members of creditors' committees who trade on this material, non-public information have the opportunity to make substantial profits.

Over the past several years, numerous publications have reported

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1. The terms "confidential information," "inside information" and "material, nonpublic information" are used synonymously in this Article.

2. *SEC Probes Distressed Debt Trading By Creditors' Committees*, BONDWEEK, Sept. 21, 1992, at 1.

widespread insider trading by members of creditors' committees,<sup>3</sup> and increased interest by the U.S. Securities and Exchange Commission ("SEC" or "Commission") in ferreting out alleged abuses by members of creditors' committees.<sup>4</sup> On October 27, 1993, the SEC settled the first insider trading case in which the relevant information was obtained as a result of an individual's participation on a creditors' committee. In *SEC v. Baker*,<sup>5</sup> the SEC charged that Sherman Baker, a member of the official creditors' committee in the Chapter 11 bankruptcy proceedings of Ames Department Stores ("Ames") and chairman of the board of J. Baker, Inc. ("Baker, Inc."), sold Baker, Inc. stock after learning that the creditors' committee planned to recommend that Ames close many of the department stores in which Baker, Inc. operated leased shoe departments.<sup>6</sup> The complaint alleged that Sherman Baker "breached fiduciary duties or other duties of trust or confidence to Baker, Inc. and its shareholders, and to the Creditors' Committee and creditors of Ames."<sup>7</sup>

*Baker* is noteworthy because it is the first insider trading case

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3. See Laurie P. Cohen & Kevin G. Salwen, *SEC Starts Insider-Trading Probe In Junk-Bond Market*, WALL ST. J., Apr. 10, 1991, at C1 (reporting that the SEC began investigations into insider trading in junk-bond market, in response to investor concern that such trading was widespread); Matthew Schiffrin, *Sellers Beware*, FORBES, Jan. 21, 1991, at 36 (noting that inside trading by creditors' committees is widespread and subject to very little SEC regulation).

4. In September of 1992, BONDWEEK reported that the SEC was investigating "three or four cases" of insider trading by members of creditors' committees. *SEC Probes Distressed Debt Trading By Creditors' Committees*, supra note 2, at 1. Alan M. Cohen, head of the securities and commodities subcommittee of the ABA's White Collar Crime Committee said that the SEC is "on the warpath" and "is looking to make a case." Karen Donovan, *N.Y.'s SEC Targets Insider Trading in Bankruptcy Debt*, NAT'L L.J., Sept. 7, 1992, at 15. The National Law Journal also quoted William R. McLucas, the SEC's Director of Enforcement, as saying that trading by creditors' committee members "is an area where there's a lot of activity. . . . There's just a growing concern that you don't want for there to be abuses." *Id.* Richard Walker, head of the SEC's New York regional office was quoted by Reuters as saying, "I think people on creditors' committees sometimes have access to confidential information that others would not have access to. . . . It is something the Commission has been interested in." Gail Appleson, *SEC Probes Bankruptcy Cases for Insider Trading*, THE REUTERS BUS. REPORT, Sept. 3, 1992, available in LEXIS, News Library, REUBUS File.

Both SEC divisions have also taken note of the trading activities of institutions with creditors' committee membership. On August 9, 1992, Marianne Smythe, then Director of the Division of Investment Management, warned that advisers for institutional investors must be "more vigilant" in preventing insider trading when investing in distressed or bankrupt companies. *Insider Trading Problems May Arise for Institutional Investors Smythe Cautions*, SEC Reg. & L. Rep. (BNA) No. 34, at 1295 (Aug. 21, 1992).

5. SEC. Reg. & L. Rep. (BNA) No. 25, at 1463 (Oct. 29, 1993).

6. SEC Lit. Rel. No. 13850, 55 SEC Docket 823 (Oct. 27, 1993).

7. SEC's Complaint at 6, *SEC v. Baker*, No. 93 Civ. 7398 (RWS) (S.D.N.Y. filed Oct. 26, 1993).

involving a member of a creditors' committee who traded on information acquired while participating on the committee.<sup>8</sup> The case does not, however, illuminate the extent to which members of creditors' committees may be liable for violating the federal securities laws because, despite the broad allegations, the case was never tried. Moreover, Baker's alleged unlawful activity involved trading in the securities of his *own* company, trading which could have been found to have violated the antifraud provisions of the federal securities laws under well-established insider trading principles. This Article seeks to resolve the more tangled question — whether a member of a creditors' committee such as Baker would be liable under the federal securities laws<sup>9</sup> if he or she traded in the securities of the debtor corporation.<sup>10</sup>

Part I of this Article explores the powers and functions of official and unofficial creditors' committees. Then, Part II examines the federal securities laws and restrictions on insider trading; and Part III addresses the imposition of the antifraud provisions of the federal securities laws to insider trading by members of official and unofficial creditors' committees.

This Article concludes that members of official and unofficial creditors' committees, who purchase or sell, or tip others to purchase or sell, securities of financially distressed or insolvent corporations while in possession of material, nonpublic information may violate the antifraud provisions of the federal securities laws pursuant to two theories. First, committee members may owe fiduciary duties to the class of creditors they represent, the committee itself and fellow committee members. Members of the creditors' committees who misappropriate material, nonpublic information in breach of their duties to their constituents, the committee itself and other commit-

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8. SEC. Reg. & L. Rep. (BNA) No. 25, at 1463 (Oct. 29, 1993).

9. The analysis in this Article is limited to the question of whether the two government organizations charged with enforcing the federal securities laws, the SEC and the Justice Department, may successfully prosecute insider trading by members of official and unofficial creditors' committees. Whether private litigants have standing to bring similar actions is a question beyond the scope of this Article.

10. Some commentators have suggested that following the filing of a Chapter 11 petition, trade claims may be characterized as securities. See Chaim J. Fortgang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 46-56 (1990) (noting that once a Chapter 11 petition is filed, general unsecured trade debt takes on some aspects of a security); James D. Pendergast, *Applying Federal Securities Law to the Trading in Bankruptcy Claims*, 3 F & G BANKR. L. REV. 9, 12 (1992) (stating that the filing of a bankruptcy petition transforms trade claims into securities because the possessor has a claim to a pay out from the debtor's estate).

tee members and who trade on that information violate Rule 10b-5. Second, committee members may be characterized as "temporary insiders," and as such, are subject to the same insider trading restrictions as "true" insiders such as directors, officers and controlling shareholders.

## I. FORMATION, FUNCTION AND GOVERNANCE

Official creditors' committees are empowered by the Bankruptcy Reform Act of 1978 ("the Bankruptcy Code")<sup>11</sup> to supervise the reorganization of debtors and to assist in the formulation of reorganization plans. The Bankruptcy Code governs the composition, duties and responsibilities of such committees.<sup>12</sup>

Unofficial creditors' committees, also known as creditor steering committees, are composed of creditors, typically bondholders, who devise and negotiate out-of-court restructuring plans with issuers.<sup>13</sup> Unofficial creditors' committees are formed before a company's Chapter 11<sup>14</sup> filing and therefore they are not supervised by the courts. However, pursuant to Section 1102(b)(1), a pre-petition committee may later be appointed as an official creditors' committee if the court determines that the committee was "fairly chosen and is representative of the different kinds of claims to be represented."<sup>15</sup>

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11. The Bankruptcy Code, 11 U.S.C. §§ 101-1330 (1988). The provisions of the Code became effective on October 1, 1979.

12. The Bankruptcy Code significantly altered the function of creditors' committees from that enumerated under the provisions of the Bankruptcy Act of 1898. The Bankruptcy Act of July 2, 1898, ch. 541, 30 Stat. 544 *repealed by* The Bankruptcy Code, 11 U.S.C. § 101-1330 (1988 & Supp. III 1991). The most significant change was the transfer of responsibility for monitoring the debtor from bankruptcy judges to creditors' committees. *See* Dennis S. Meir & Theodore Brown, Jr., *Representing Creditor's Committees Under Chapter 11 of the Bankruptcy Code*, 56 AM. BANKR. L.J. 217, 217 (1982) (stating that by enacting the code, Congress "expressed a clear intent to limit the duties of bankruptcy judges to those of a judicial nature. This has resulted to a great extent in the shift of the responsibility for monitoring Chapter 11 debtors to creditors' committees, and, as a result, the role of committees of unsecured creditors under the Code is far more important than that of creditors' committees under [the Act]").

13. Peter D. Wolfson et al., *Restrictions in Trading by Pre-Petition Steering Committee Members*, in *HIGH-YIELD BONDS 1991: RECENT TRENDS IN WORKOUTS, EXCHANGE OFFERS, AND BANKRUPTCY*, 177, 179 (PLI Real Est. Law Practice Course Handbook Series No. 376, 1991).

14. Chapter 11 of the Bankruptcy Code allows a business to reorganize as a going concern. It provides the debtor with time to rescale its operations and to negotiate a plan of repayment that is acceptable to its creditors. *See generally* 11 U.S.C. §§ 101-1330 (1988).

15. *Id.* § 1102(b)(1). Bankruptcy Rule 2007 sets forth the test used to determine whether the committee in existence prior to the Chapter 11 filing meets the Code's requirements of being "fairly chosen" and "representative." 11 U.S.C. § 2007 (Supp. V 1993) (as amended April 30, 1991) (effective August 1, 1991). The rule states:

(b) Selection of Members of Committee

### A. Official Creditors' Committees

Under the Bankruptcy Code, the appointment of an official unsecured creditors' committee is mandatory in all Chapter 11 cases;<sup>16</sup> the Bankruptcy Code provides that "as soon as practicable after the order for relief," the United States trustee<sup>17</sup> shall appoint an unsecured creditors committee.<sup>18</sup> The U.S. trustee may exercise broad discretion when appointing members of the creditors' committee; however, the Bankruptcy Code provides some regulation. For example, section 1102(b)(1) states that the committee shall ordinarily consist of persons who are willing to serve and who hold the seven largest claims against the debtor.<sup>19</sup> In addition to the unsecured creditors' committee, the U.S. trustee has the discretion to appoint any additional committees.<sup>20</sup> Section 1102(a)(2) provides that if a party in interest makes a request, the court may order the U.S. trustee to appoint additional committees of creditors, if necessary to ensure their adequate representation in the case.<sup>21</sup> The committees could include, among others, committees of bondholders, priority creditors and equity security holders.<sup>22</sup> A committee appointed pur-

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The court may find that a committee organized by unsecured creditors before the commencement of a chapter 9 or chapter 11 case was fairly chosen if:

(1) it was selected by a majority in number and amount of claims of unsecured creditors who may vote under § 702(a) of the Code and were present in person or represented at a meeting of which all creditors having unsecured claims of over \$1,000 or the 100 unsecured creditors having the largest claims had at least five days notice in writing, and of which meeting written minutes reporting the names of the creditors present or represented and voting and the amounts of their claims were kept and are available for inspection;

(2) all proxies voted at the meeting for the elected committee were solicited pursuant to Rule 2006 and the lists and statements required by subdivision (e) thereof have been transmitted to the United States trustee; and

(3) the organizations of the committee were in all other respects fair and proper.

*Id.*

16. Under the Bankruptcy Act, the appointment of creditors' committees was permissive. The Bankruptcy Act of July 2, 1898, ch. 541, 30 stat. 544 *repealed by* The Bankruptcy Code, 11 U.S.C. §§ 101-1330 (1988).

17. Prior to the 1986 Amendments to the Code, courts appointed the members of the creditors' committee. In order to ease the administrative duties of the courts, Congress gave the responsibility for appointing committee members to the U.S. trustee. 11 U.S.C. § 1102 (1988) (as stated in historical note following § 1102).

18. *Id.* § 1102(a)(1).

19. The list of such persons is furnished by the debtor. *See id.* § 1007(a).

20. *Id.* § 1102(a)(1).

21. The appointment of additional committees is discretionary with the court. *In re Salant Corp.*, 53 B.R. 158 (Bankr. S.D.N.Y. 1985); *see also In re McLean Indus. Inc.*, 70 B.R. 852, 856-57 (Bankr. S.D.N.Y. 1987).

22. *McLean Indus.*, 70 B.R. at 856-57.

suant to section 1102(a)(2) has the same rights and duties as secured committees appointed pursuant to section 1102(a)(1).<sup>23</sup>

The Bankruptcy Code enumerates the powers and duties entrusted to creditors' committees.<sup>24</sup> Specifically, section 1103(c)(1) reveals that the role of the creditors' committee is advisory or consultative rather than controlling.<sup>25</sup> Section 1103(c)(2) allows creditors' committees to investigate the acts, conduct and financial affairs of the debtor.<sup>26</sup> The committee's investigatory power is expansive; it includes all matters relevant to the case or to the formulation of the reorganization plan.<sup>27</sup>

Section 1103(c)(3) further authorizes official creditors' committees to participate in the formulation of a reorganization plan.<sup>28</sup> A committee is expressly empowered to advise its constituency about the merits of any proposed plan.<sup>29</sup> After the debtor's statutorily defined period to file a plan elapses,<sup>30</sup> "any party in interest," includ-

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23. *In re Evans Products Co.*, 58 B.R. 572, 575 (Bankr. S.D. Fla. 1985).

24. Section 1103(c), states:

A committee appointed under section 1102 of this title may — (1) consult with the trustee or debtor in possession concerning the administration of the case;

(2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;

(3) participate in the formulation of a plan, advise those represented by such committee of such committee's determination as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;

(4) request the appointment of a trustee or examiner under section 1104 of this title; and

(5) perform such other services as are in the interest of those represented.

11 U.S.C. § 1103(c) (1988).

25. *Id.* § 1103(c)(1).

26. *Id.* § 1103(c)(2).

27. Marta G. Andrews, *The Chapter 11 Creditors' Committee: Statutory Watchdog?*, 2 BANK. DEV. J. 247, 251 (1985). Among other things, courts have determined that a thorough investigation is crucial to the committee's ability to make an informed decision about the feasibility of a reorganization plan. See *In re Structurlite Plastics Corp.*, 91 B.R. 813, 819-20 (Bankr. S.D. Ohio 1988) (permitting creditors' committee to have access to confidential information to enable committee to evaluate and advise its constituency on potential sale of debtor's assets); see also *In re Wilson Foods Corp.*, 31 B.R. 272, 272 (Bankr. W.D. Okla. 1983) (authorizing creditors' committee to fully investigate the debtor and its business affairs).

28. 11 U.S.C. § 1103(c)(3) (1988). See *In re Johns-Manville Corp. v. Doan*, 26 B.R. 919, 925 (Bankr. S.D.N.Y. 1983) (stating that creditors' committees are vested with "a wide and important array of authority indicating the intent to create a significant and central role for committees in carrying out a reorganization").

29. 11 U.S.C. § 1103(c)(3) (1988).

30. Only the debtor may file a plan during the first 120 days after the entry of the order for relief, unless the court orders a shorter period. *Id.* § 1121(b).



ing the creditors' committee, may file a reorganization plan.<sup>31</sup> Furthermore, a committee can be influential in negotiating the terms of any proposed plan — rejection by a committee will often prevent a plan from being accepted.<sup>32</sup>

### B. Creditor Steering Committees

In contrast to official creditors' committees in bankruptcy cases, creditor steering committees (unofficial creditors' committees) are not formed pursuant to statute; they have no powers or responsibilities except those that they assume themselves or those that they are given by others.<sup>33</sup> Further, the very process in which they are functioning — the workout — is an "entirely consensual one that has no governmental sanction or oversight."<sup>34</sup> However, creditor steering committees may, by mutual assent, adopt bylaws to govern the committee's actions and relationship with other parties.

## II. INSIDER TRADING

### A. Statutory Authority

The primary weapon in the SEC's battle against insider trading is section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act").<sup>35</sup> Developed as a catchall provision to prevent fraudulent practices,<sup>36</sup> section 10(b) prohibits the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and reg-

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31. *Id.* § 1121(c).

32. Peter C. Blain & David A. Erne, *Creditors' Committees Under Chapter 11 of the United States Bankruptcy Code: Creation, Composition, Powers, and Duties*, 67 MARQ. L. REV. 491 (1984).

33. Wolfson, *supra* note 13, at 177.

34. Mark D. Brodsky et al., *Restrictions on Trading By Creditor Steering Committee Members During Out of Court Restructurings*, in HIGH YIELD BONDS 1990: WORKOUTS, EXCHANGE OFFERS, AND BANKRUPTCY, 591, 610 (PLI Real Est. Practice Course Handbook Series No. 591, Nov. 1990); see generally Lillian E. Kramer & Richard Paige, *Consensual Workouts-Bankruptcy Alternatives for the 1990s?*, in BANKING AND COMMERCIAL LENDING LAW, (ALI-ABA Course of Study Handbook Series No. 419, 1994).

35. 15 U.S.C. § 78j(b) (1988). In 1980, the Commission promulgated Rule 14e-3. Rule 14e-3(a) provides that any person who obtains inside information regarding a tender offer from either the offeror or the target must either disclose the information or abstain from trading. Rule 14e-3 does not require the Commission to prove that the tender offer information was obtained pursuant to a breach of a fiduciary duty. 17 C.F.R. § 240.14e-3 (1994)(pursuant to Section 14(e) of the 1933 Exchange Act, 15 U.S.C. § 78(n)(e) (1988)).

36. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202 (1976).

ulations as the Commission may prescribe.”<sup>37</sup> Pursuant to this section, the SEC promulgated Rule 10b-5.<sup>38</sup>

Neither section 10(b) nor its legislative history specifically state whether or not a corporate insider’s failure to disclose inside information prior to trading is actionable under the statute.<sup>39</sup> Further, the Commission did not address this issue when it promulgated Rule 10b-5 in 1942.<sup>40</sup> Therefore, it is necessary to examine administrative and federal court decisions to determine the effects of an individual’s failure to disclose material, nonpublic information.<sup>41</sup> These decisions may be divided into two main theories: the classical theory<sup>42</sup> and the misappropriation theory.<sup>43</sup>

## B. Judicial Interpretation

### 1. Classical Theory

The classical theory generally provides that for a duty to disclose to exist, there must be a fiduciary relationship between a corporate insider and a stockholder.<sup>44</sup> This theory of insider trading analysis is illustrated in several cases. First, in *In re Cady, Roberts & Co.*,<sup>45</sup> the Commission imposed an affirmative duty on corporate insiders — traditionally, officers, directors and controlling stockholders — to disclose all material, nonpublic information or abstain from trading.<sup>46</sup> The obligation to disclose information to shareholders or abstain from trading arose from: 1) “the existence of a relationship

37. 15 U.S.C. § 78j(b) (1988).

38. 17 C.F.R. § 240.10b-5 (1994). Rule 10b-5 provides, in pertinent part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud, [or] . . .

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

*Id.*

39. *Chiarella v. United States*, 445 U.S. 222, 226 (1980).

40. See Exchange Act Release No. 3230, 7 Fed. Reg. 3804 (May 21, 1942).

41. *Chiarella*, 445 U.S. at 226.

42. For a discussion of decisions following the classical theory, see *infra* notes 44-67 and accompanying text.

43. For a discussion of decisions following the misappropriation theory, see *infra* notes 68-91 and accompanying text.

44. See *infra* notes 44-67 and accompanying text.

45. 40 S.E.C. 907 (1961).

46. *Id.* at 911.

giving access, directly or indirectly, to information intended to be available only for a corporate purpose . . . and 2) the inherent unfairness when a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."<sup>47</sup>

In *Chiarella v. United States*,<sup>48</sup> the Supreme Court found no general duty to disclose material, nonpublic information before trading on the information.<sup>49</sup> The Court held that a duty to disclose under section 10(b) does not arise from the mere possession of material, nonpublic information;<sup>50</sup> instead, the duty springs from the existence of a fiduciary relationship between corporate insiders and the stockholders of the corporation.<sup>51</sup>

In *Chiarella*, a "markup man" employed at a financial printing company gleaned the identity of takeover targets and traded on the information.<sup>52</sup> Because *Chiarella* had no prior relationship with the target company shareholders, was not a corporate insider in the target company, and did not receive confidential information from the target company, the Supreme Court found that he did not owe a duty to the target company shareholders.<sup>53</sup> In his opinion, Justice Powell acknowledged that section 10(b) is a catchall provision, but noted that "what it catches must be fraud."<sup>54</sup> He further stated, "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."<sup>55</sup>

Three years later, the Supreme Court addressed the obligations of "tippees" — recipients of material, nonpublic information. In *Dirks*

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47. *Id.* at 912; see also *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (reaffirming the Commission's view that a fiduciary's failure to disclose confidential information was actionable under section 10(b)), *cert. denied*, 404 U.S. 1005 (1971).

48. 445 U.S. 222 (1980).

49. *Id.* at 235.

50. *Id.*

51. *Id.* at 227-35.

52. Since speculation of an upcoming tender offer will invariably cause the target company's stock price to rise, information about proposed offers is closely guarded prior to the public announcement. It is common for firms to leave blanks for the name of the target and masquerade specifics about the entity. *United States v. Reed*, 601 F. Supp. 685, 702 n.27 (S.D.N.Y. Jan. 24, 1985), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985).

53. *Chiarella*, 445 U.S. at 232-233 ("He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.").

54. *Id.* at 235.

55. *Id.* Further, the court specifically rejected the need for "equality of information" which required those in the market with superior information about a stock to disclose or refrain from trading on the information. *Id.* at 232-33.

v. SEC,<sup>56</sup> Dirks, an investment analyst for a broker-dealer firm, was told by Secrist, a former officer of Equity Funding of America ("Equity Funding"), that Equity Funding's assets were vastly overstated because of fraudulent practices.<sup>57</sup> Secrist revealed the information to Dirks in hopes that Dirks would expose the fraudulent activity.<sup>58</sup> Dirks conducted an investigation which partially verified Secrist's statements. During his investigation, Dirks passed his findings on to investors and customers, some of whom subsequently sold Equity Funding securities.<sup>59</sup> After the fraud was fully exposed, the SEC, based on the findings of an administrative law judge that Dirks had aided and abetted violation of the federal securities laws, censured Dirks for informing investors and customers of his findings.<sup>60</sup> Dirks appealed the ruling to the court of appeals, which affirmed the SEC's ruling, and then went to the Supreme Court, which reversed the finding of the administrative law judge.<sup>61</sup>

In *Dirks*, the Court held that a tippee's duty to disclose information or abstain from trading is derivative from that of an insider's duty:<sup>62</sup>

[a] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.<sup>63</sup>

The Court further stated that in determining whether or not an insider breached his fiduciary duty to the corporation by disclosing information to a tippee, courts must analyze the insider's purpose in disclosing information to the tippee.<sup>64</sup> Specifically, courts must consider "whether the insider receives a direct or indirect personal benefit from the disclosure, such as pecuniary gain or a reputational benefit that will translate into future earnings."<sup>65</sup> Additionally, the Court found that "[t]he elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of

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56. 463 U.S. 646 (1983).

57. *Id.* at 649.

58. *Id.*

59. *Id.*

60. *Id.* at 651-52.

61. *Id.* at 652.

62. *Id.* at 659.

63. *Id.* at 660.

64. *Id.* at 662.

65. *Id.* at 663.

confidential information to a trading relative or friend.”<sup>66</sup> Finally, the Supreme Court concluded that Dirks had no duty to abstain from the use of inside information that he obtained since the corporate insiders, motivated by a desire to expose fraud, received no monetary or personal benefit from revealing the information, nor was there a gift of information to Dirks.<sup>67</sup> Thus, the classical theory is based on the premise that a duty to disclose must exist and be breached before an individual may be held liable.

## 2. *Misappropriation Theory*

The misappropriation theory is the government’s most flexible means of combatting insider trading.<sup>68</sup> Generally, the theory provides that there is a Rule 10b-5 violation when a person misappropriates material, nonpublic information in breach of a duty arising out of a relationship of trust and confidence and trades while in possession of that information. The person need not owe any duties to the shareholders of the traded stock.<sup>69</sup>

The misappropriation theory first received judicial recognition in Chief Justice Burger’s dissent in *Chiarella*.<sup>70</sup> Chief Justice Burger remarked that *Chiarella* “misappropriated — stole to put it bluntly — valuable nonpublic information entrusted to him in the utmost confidence.”<sup>71</sup> Chief Justice Burger suggested the limitless proposition that an absolute duty to disclose information or refrain from trading arises when a person has “misappropriated” inside

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66. *Id.* at 664.

67. *Id.* at 667.

68. See Harvey L. Pitt & Karl A. Groskaufmanis, *A Tale of Two Instruments: Insider Trading in Non-Equity Securities*, 49 BUS. LAW. 187, 242 (1993).

69. SEC v. Cherif, 933 F.2d 403, 409 (7th Cir. 1991) (“The misappropriation theory focuses not on the insider’s fiduciary duty to the issuing company or its shareholders, but on whether the insider breached a fiduciary duty to any lawful possessor of material non-public information.”).

70. The government advanced the “misappropriation theory” to the Court in *Chiarella* — arguing that *Chiarella* breached a duty to the acquiring company when he traded on information entrusted to him by his employer. *Chiarella v. United States*, 445 U.S. 222, 235 (1980). However, Justice Powell writing for the majority, declined to address the theory/argument because it was not raised at trial and, accordingly, not submitted to the jury. *Id.* at 236. However, a concurring opinion and both dissenting opinions suggested that “had the misappropriation theory been presented to the jury and argued to the Court, the conviction might have been affirmed.” *Id.* at 238-39 (Brennan, J., concurring); *id.* at 245 (Burger, C.J., dissenting); *id.* at 245-246 (Blackmun, J., dissenting); accord *Cherif*, 933 F.2d at 409-10 (noting that the Supreme Court “had declined to comment on the viability of the misappropriation theory” but that the theory had nonetheless been adhered to by “numerous circuit and district courts despite the lack of explicit approval by the Supreme Court”).

71. *Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting).

information.<sup>72</sup>

In *U.S. v. Newman*<sup>73</sup> the Second Circuit adopted Burger's misappropriation theory in name only.<sup>74</sup> Although the Second Circuit referred to Chief Justice Burger's dissent in *Chiarella*, it did not embrace his expansive view of the theory.<sup>75</sup> In *Newman*, the Second Circuit reversed the dismissal of an indictment charging employees of Morgan Stanley and Kuhn Loeb, investment banking firms, with misappropriating information concerning the identity of merger and acquisition targets and with trading on the basis of the information.<sup>76</sup> The court held that the breach of fiduciary duties owed by the alleged inside traders to their employer<sup>77</sup> could support a Rule 10b-5 conviction, even in the absence of any duties owed by the company whose shares the inside traders bought.<sup>78</sup> The Second Circuit found that the defendants' actions "sull[ied] the reputations of [the firms] as safe repositories of client confidences . . . and defrauded those employers as surely as if they took their money."<sup>79</sup>

Following *Newman*, the Second Circuit decided *SEC v. Materia*.<sup>80</sup> *Materia*, like *Chiarella*, involved a financial printing firm employee who purchased the securities of takeover targets. In *Materia*, the SEC alleged that Materia, the employee, perpetrated a fraud on his employer when he misappropriated material, nonpublic information.<sup>81</sup> The Second Circuit found that by misappropriating confidential information from his employer and trading on the information to his own advantage, Materia violated section 10(b) and Rule 10b-5.<sup>82</sup> The court stated that "[b]y purloining and trading on

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72. *Id.* at 240; see also *SEC v. Clark*, 915 F.2d 439, 445 (9th Cir. 1990) (quoting Burger's dissent in *Chiarella*).

73. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

74. *SEC v. Clark*, 699 F.Supp. 839, 843 (W.D. Wash. 1988) (stating that the Second Circuit adopted Burger's view "in name but the application has been modified in order to make it more specific and consistent), *aff'd*, *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990) *cert. denied*, 465 U.S. 1025 (1984)).

75. *Clark*, 915 F.2d at 445. *Clark* cites *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 16 (2d Cir. 1983) which describes Burger's view of the misappropriation theory as "contrary to the holdings in *Chiarella* and *Dirks*."). *Id.* at 445 n. 8.

76. *Moss*, 719 F.2d at 14.

77. The Second Circuit also stated that Morgan Stanley and Kuhn Loeb's clients were "wronged" since an increase in purchases of the target companies securities drives up the price of the targets company's shares and the price ultimately paid by the buyer. *Id.* at 17-18.

78. *Id.* at 16.

79. *Id.* at 17.

80. 745 F.2d 197 (2d Cir. 1984).

81. *Id.* at 202.

82. *Id.* at 203.

confidences entrusted to [the printer], it cannot be gainsaid that Materia undermined his employer's integrity."<sup>83</sup> The Second Circuit underscored that Materia's actions fit neatly within the "fraud or deceit" language of the rule,<sup>84</sup> concluding that section 10(b) is not "aimed solely at the eradication of fraudulent trading by corporate insiders."<sup>85</sup>

In 1987, the Supreme Court finally addressed the validity of the misappropriation theory. A 4-4 vote in *Carpenter v. United States*<sup>86</sup> affirmed the conviction of a Wall Street Journal writer who, with the aid of accomplices, traded on information obtained for and used in his upcoming columns. The column, "Heard on the Street," tended to effect the price of any stock analyzed in it.<sup>87</sup> The columnist traded on the probable market impact of the information.<sup>88</sup> After characterizing the contents of the column as the Journal's confidential information,<sup>89</sup> the Court held that the "deliberate breach of Winans' [the columnist] duty of confidentiality and concealment of the scheme was a fraud and deceit on the Journal."<sup>90</sup> Since *Carpenter*, and despite its 4-4 vote, the misappropriation theory has been widely applied in various circuits.<sup>91</sup>

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83. *Id.* at 202.

84. *Id.* at 201.

85. *Id.*

86. 484 U.S. 19 (1987).

87. *Id.* at 22.

88. *Id.* at 23.

89. *Id.* at 26-27.

90. *Id.* at 24. *Carpenter* is unique because the source of the information, the Wall Street Journal, neither traded in the securities nor received its information from corporate clients which intended to trade in the securities. See *SEC v. Clark*, 915 F.2d 439, 445 (9th Cir. 1990) (discussing the uniqueness of the *Carpenter* case).

91. The misappropriation theory has been applied in the following circuits:

*Second Circuit*

*United States v. Grossman*, 843 F.2d 78 (2d Cir. 1988) (applying the misappropriation theory to an attorney who traded on confidential information learned at law firm), *cert. denied*, 488 U.S. 1040 (1989); *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981) *cert. denied*, 464 U.S. 863 (1983); *United States v. Willis*, 737 F. Supp. 269, 274 (S.D.N.Y. 1990) (applying the misappropriation theory to a psychiatrist who traded on nonpublic information learned from patient, and observing that "[t]he underlying rationale of the misappropriation theory is that a person who receives secret business information from another because of an established relationship of trust and confidence between them has a duty to keep the information confidential"); *United States v. Marcus Schloss & Co.*, 710 F. Supp. 944 (S.D.N.Y. 1989) (applying theory to a corporate insider); *SEC v. Tome*, 638 F.Supp. 596, 617-18 (S.D.N.Y. 1986) ("The common-sense notion underlying the misappropriation theory is that one who misappropriates valuable information for his own benefit, in breach of a fiduciary or similar duty of trust and confidence, has surely committed fraud on the person or entity to whom that duty is owed."),

### a. Congressional Support

Members of the United States Congress have also endorsed the misappropriation theory. The theory is expressly addressed in discussions of the Insider Trading Sanctions Act of 1984 ("ITSA") and the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA").<sup>92</sup>

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*aff'd*, 833 F.2d 1086 (2d Cir. 1987); *SEC v. Musella*, 578 F. Supp. 425, 438 (S.D.N.Y. 1984) (recognizing that *Newman* "gave legal effect to the commonsensical view that trading on the basis of improperly obtained information is fundamentally unfair, and that distinctions premised on the source of the information undermine the prophylactic intent of the securities laws").

#### *Third Circuit*

*Rothberg v. Rosenbloom*, 771 F.2d 818, 822 (3d Cir. 1985) (holding that an insider violates the federal securities laws "when he uses insider information in violation of the fiduciary duty owed to the corporation to which he owes a duty of confidentiality."), *cert. denied*, 481 U.S. 1017 (1987).

#### *Seventh Circuit*

*SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991). Cherif argued that no fiduciary duty existed between him and his former employer at any time he obtained material, nonpublic information from the offices of his former employer. The court held that "[n]otwithstanding the contractual agreement, Cherif was bound by a broader common law duty. This common law duty obligates an employee to protect any confidential information entrusted to him by his employer during his employment." *Id.* at 411.

#### *Ninth Circuit*

*SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990) (applying the misappropriation theory to president of subsidiary, who, based on conversations with insiders and knowledge of the health care industry, determined that the parent of the subsidiary planned to make a major acquisition and traded on the basis of the information). The court concluded, "by becoming part of a fiduciary or similar relationship, an individual is implicitly stating that she will not divulge or use to her own advantage information entrusted to her in the utmost confidence. She deceives the other party by playing the role of the trustworthy employee or agent; she defrauds it by actually using the stolen information to its detriment." *Id.* at 448.

District courts in other circuits have also adopted the misappropriation theory:

*SEC v. Callahan*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,609 at 97,848 (C.D. Cal. 1990) (imposing liability for misappropriation of information by an employee of R.R. Donnelly, the company that prints the upcoming issues of *BusinessWeek* or *BusinessWeek's* "Inside Wall Street" column); *United States v. Elliott*, 711 F. Supp. 425 (N.D. Ill. 1989) (concluding that "under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders"); *SEC v. Peters*, 735 F. Supp. 1505 (D. Kan. 1990) (imposing federal securities fraud liability based on misappropriation theory to partner in investment company even though partner had no direct fiduciary relationship to the issuing company other than partnership agreement with consulting firm).

92. The Second Circuit in *Carpenter*, found Congress' statements accompanying ITSA "persuasive" in determining Congressional intent in connection with restrictions on insider trading imposed by the Exchange Act. 791 F.2d at 1030 (citing *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985) which construed section 10(b) in light of the provisions and legislative history of ITSA); *see also* *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 380-81, (1969) (stating that subsequent legislation declaring the intent of the earlier statute is "entitled to great weight in [prior] statutory construction"); *Consolidated Edison Co. v. United States*, 782 F.2d 322, 324 n.3 (2d Cir. 1986) (*per curiam*) (noting persuasiveness of subsequent legislative history as to meaning of prior law). "The use of subsequent legislative history is especially appropriate



In enacting the Insider Trading Sanctions Act of 1984, which amended certain provisions of the Exchange Act of 1934,<sup>93</sup> Congress noted that the intent of the Exchange Act was to condemn all manipulative or deceptive trading "whether the information about a corporation or its securities originates from inside or outside the corporation."<sup>94</sup> The basis for this view was that "the abuses sought to be remedied [by section 10(b)] were not limited to actions of corporate insiders and large shareholders."<sup>95</sup>

The House Report further stated that "deceitful misappropriation of confidential information by a fiduciary" has consistently been held to be unlawful in various areas of the law, and that, "Congress has not sanctioned a less rigorous code of conduct under the federal securities laws."<sup>96</sup> In 1988, the House Committee reporting on IT-SFEA commented that the "type of security fraud" for which the misappropriation theory addressed "should be encompassed within section 10(b) and Rule 10b-5."<sup>97</sup> Commenting on Congress' willingness to include the misappropriation theory in the net of items ensnared by Section 10(b) and Rule 10b-5, the court of appeals in *Carpenter* stated:

Clearly, Congress has understood its predecessors to have delineated illegal conduct along the lines not simply of relationships to corporations and duties arising thereunder, as developed by the line of cases through *Cady*, *Roberts* and *Dirks*.<sup>98</sup>

The court continued:

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where, as here, the original history is limited." *Carpenter*, 791 F.2d at 1030 (citing *Santa Fe Indus. v. Green*, 430 U.S. 462, 473 n.13 (1977) which noted the lack of legislative history on section 10(b)); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201-206 (1976) (concluding that the legislative history of the Exchange Act does not provide an explicit explanation of the standard of liability).

93. H.R. Rep. No. 98-355, 98th Cong., 1st Sess. 3, 4 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2277.

94. *Id.*

95. *Id.* at 2276.

96. H.R. Rep. No. 355, 98th Cong., 2d Sess. 5 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2278. *But see* *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 114 S. Ct. 1493, 1452-53 (1994) (declining to find that Congress acquiesced to judicial interpretations of section §10(b) as including aiding and abetting liability, when it did not address the issue when it amended the securities laws). The Supreme Court stated, "It does not follow . . . that Congress' failure to overturn a statutory precedent is reason for this Court to adhere to it. It is 'impossible to assert with any degree of assurance that Congressional failure to act represents affirmative Congressional approval of the [courts'] statutory interpretation . . .'" *Id.* at 1453.

97. *SEC v. Cherif*, 933 F.2d 403, 410 n.5 (7th Cir. 1991) (citing, H.R. Rep. No. 910, 100th Cong., 2d Sess. (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6047).

98. *Carpenter v. United States*, 791 F.2d 1024, 1030-31 (2d Cir. 1986).

Rather, Congress apparently has sought to proscribe as well trading on material, nonpublic information obtained not through skill but through a variety of "deceptive" practices, unlawful acts which we term "misappropriation."<sup>99</sup>

b. *United States v. Chestman*<sup>100</sup>

*United States v. Chestman*<sup>101</sup> placed some limitations on the government's use of the misappropriation theory.<sup>102</sup> In *Chestman*, the government alleged that Robert Chestman obtained material, nonpublic information from a client who had obtained the information in breach of a relationship of trust and confidence owed to his wife and her family.<sup>103</sup> In an en banc decision, the Second Circuit Court of Appeals held that the relationship of husband and wife does not, in itself, create a fiduciary duty sufficient to establish criminal liability under the misappropriation theory.<sup>104</sup> The court stated that the legal standard for establishing a fiduciary relationship is "reliance, and de facto control and dominance."<sup>105</sup> The court found that a fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information, and marriage does not, without more, create a fiduciary relationship.<sup>106</sup>

The ramifications of *Chestman* are not entirely discernable at this point. The decision may simply rebuke any presumption that the marital relationship constitutes a fiduciary relationship, and thus have limited impact.<sup>107</sup> On the other hand, some commentators ar-

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99. *Id.* at 1031 (citing Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 106 n.33 (1984)). See also ABA Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading—Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934*, 41 BUS. LAW. 223, 235-37, 253-63, 270-71 (1985).

100. 947 F.2d 551 (2d Cir. 1991) (en banc).

101. *Id.*

102. See Pitt & Groskaufmanis, *A Tale of Two Instruments*, *supra* note 68, at 39.

103. *Chestman*, 947 F.2d at 555-56.

104. *Id.* at 568.

105. *Id.* (quoting *U.S. v. Margiotta*, 688 F.2d 108, 125 (2d Cir. 1982)). "The relation exists when confidence is reposed on one side and there is resulting superiority and influence on the other." *Id.* (quoting *Mobil Oil Corp. v. Rubinfeld*, 339 N.Y.S.2d 623, 632 (N.Y. Civ.Ct. 1972), *aff'd*, 357 N.Y.S.2d 57 (N.Y. App.Div. 1976)).

106. *Id.* at 568-69.

107. *SEC v. Singer*, 786 F. Supp. 1158, 1170 (S.D.N.Y. 1992) (stating, "the Court reads the *Chestman* opinion not as setting forth a rigid checklist but as a general characterization of a type of relationship in which it is appropriate to impose the responsibilities associated with a fiduciary association"); *U.S. v. Willis*, 737 F. Supp. 269, 275 (S.D.N.Y. 1990) (refusing to dismiss an indictment based on the *Chestman* decision).

gue that the decision indicates that there will be fewer relationships of "trust and confidence," the breach of which is sufficient to serve as a basis for application of the misappropriation theory.<sup>108</sup> Nevertheless, the *Chestman* decision does not affect the government's ability to use the misappropriation theory where a fiduciary relationship is definitively established.

### III. IMPOSITION OF THE FEDERAL SECURITIES LAWS TO INSIDER TRADING BY MEMBERS OF CREDITORS' COMMITTEES

#### A. Breach of Fiduciary Duties Owed by Creditors' Committee Members to Their Constituents, the Committee and Other Committee Members

Members of official creditors' committees and creditor steering committees owe fiduciary duties or other duties of trust and confidence to the class of creditors they represent (their "constituents"), the committee itself and fellow committee members. Committee members who breach these duties by fraudulently misappropriating confidential information violate Rule 10b-5.

#### 1. Official Creditors' Committees

It is a well-settled rule that official creditors' committees owe fiduciary duties to those they represent.<sup>109</sup> As fiduciaries, members of

108. Pitt & Groskaufmanis, *A Tale of Two Instruments*, *supra* note 68, at 39.

109. See *Woods v. City Nat'l Bank & Trust Co.*, 312 U.S. 262, 268 (1941); see also *Magruder v. Drury*, 235 U.S. 106, 119 (1914) (holding that trustee breached his fiduciary duties when he invested estate funds to make a personal profit for himself); *In re Bohack Corp. v. Gulf W. Indus. Inc.*, 607 F.2d 258, 262 (2d Cir. 1979) (holding that creditor's committee represents the interest of all creditors and must carry out its fiduciary duty so as to safeguard the rights of the minority as well as the majority of creditors); *In re Reynolds Investing Co.*, 130 F.2d 60, 61 (3d Cir. 1942) (holding that one who purchases or sells claims against or stock of the debtor while acting in a representative capacity is not entitled to compensation); *In re Mountain States Power Co.*, 118 F.2d 405, 407 (3d Cir. 1941) (holding that one who becomes a member and chairman of preferred stockholder committee of a corporation undergoing reorganization assumes a fiduciary duty toward such stockholders whom they represent); *In re Realty Assoc. Sec. Corp.*, 56 F. Supp. 1008, 1009 (E.D.N.Y. 1944) *aff'd*, 156 F.2d 480 (2d Cir. 1946) (granting disqualification of members of Bondholders' Directors Committee because members of committee had served as directors of debtor and thus, fiduciary duty to bondholder-creditors was jeopardized); *In re First Republicbank Corp.*, 95 B.R. 58, 61 (Bankr. N.D. Tex. 1988) ("A member of creditor's committee owes a fiduciary duty to all creditors represented by the committee."), *In re Grant Broadcasting of Phila. Inc.*, 71 B.R. 655, 661-62 (Bankr. E.D. Pa. 1987) ("the members of a Creditors' Committee have a fiduciary duty to represent the interests of all creditors . . ."); *In re Mesta Machine Co.*, 67 B.R. 151, 156 (Bankr. W.D. Pa. 1986) ("The Supreme Court has unequivocally found that creditors' committees and counsel are fiduciaries."); *In re REA Holding Corp. v. Air Canada*, 8 B.R. 75, 82 (Bankr. S.D.N.Y. 1980) (sanctioning members of creditors' committees for breaching their

official committees are bound by the "whole body of law imposing the most rigorous responsibilities for fair dealing."<sup>110</sup> Committee members are representatives of all of the creditors in their class, and must pursue their statutory function for the benefit of their constituency with an undivided loyalty.<sup>111</sup> Committee members must also vigilantly avoid conflicts of interest,<sup>112</sup> and they may not use their status to further their own interests at the expense of other creditors.<sup>113</sup>

The obligations of members of creditors' committees to their constituents was first enunciated in *Woods v. City Nat'l Bank and Trust Co.*<sup>114</sup> In *Woods*, the Supreme Court denied compensation to bondholder committee members because, *inter alia*, two of the five members of a bondholders committee were officers or employees of one of the principal underwriters of the bonds and served as the

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"fiduciary" duties); see generally Andrew DeNatale, *The Creditors' Committee Under the Bankruptcy Code - A Primer*, 55 AM. BANKR. L.J. 43 (1981); Chauncey H. Levy, *Creditors' Committees and Their Responsibilities*, 74 COMM. L.J. 355 (1969).

110. *Young v. Higbee Co.*, 324 U.S. 204, 213 (1945).

111. *Id.* at 213 ("They cannot avail themselves of the statutory privilege of litigating for the interest of a class and then shake off their self-assumed responsibilities to others by a simple announcement that henceforth they will trade in the rights of others for their own aggrandizement."); *In re Mesta Machine Co.*, 67 B.R. 151, 156 (Bankr. W.D. Penn. 1986) ("As fiduciaries, counsel and committee members have obligations of fidelity, undivided loyalty and impartial service in the interest of the creditors they represent.").

112. See *American United Mut. Life Ins. Co. v. City of Avon Park*, 311 U.S. 138, 144 (1940) ("Where it does not affirmatively appear that full and complete disclosure of the fiscal agent's interests was made to the bondholders when their assents were solicited, it cannot be said that those assents were fairly obtained."); *Bohack Corp.*, 607 F.2d at 262-63 (finding the disqualification of special counsel for the debtor in possession proper wherein the senior partner had close personal and business ties with the chairmen of the board of directors); *Grant Broadcasting*, 71 B.R. at 662-63 (holding that law firm representing unsecured program creditors was representing interest adverse to at least some of debtor's other creditors, and therefore was ineligible to be appointed counsel for creditor's committee); *In re Penn-Dixie Indust., Inc.*, 9 B.R. 941, 944 (Bankr. S.D.N.Y. 1981) (holding that a corporation's membership on reorganization committee was improper where corporation was one of debtor's major stockholders).

113. See e.g., *In re Standard Commercial Tobacco Co.*, 34 F. Supp. 304 (S.D.N.Y. 1940) (noting that in order for a committee member to purchase assets of the estate, there must be a full disclosure to the court and to all interested parties); *In re Johns-Manville*, 26 B.R. 919 (Bankr. S.D.N.Y. 1983) (sanctioning committee member who continued a pre-petition lawsuit against the debtor on behalf of a private client); see also *In re Enduro Stainless, Inc.*, 59 B.R. 603, 605 (Bankr. N.D. Ohio 1986) (stating that the "union may not act through the committee to further only its self-interests"). Cf. *Magruder*, 235 U.S. at 119 (stating that "[i]t is a well-settled rule that a trustee can make no profit out of his trust. The rule in such cases springs from his duty to protect the interests of the estate, and not to permit his personal interest to in any way conflict with his duty to that respect. The intention is to provide against any possible selfish interest exercising an influence which can interfere with the faithful discharge of the duty which is owing in a fiduciary capacity").

114. 312 U.S. 262 (1941).

indenture trustees.<sup>115</sup> The Court held that this created a conflict of interest for these two committee members,<sup>116</sup> and explained:

It is no answer to say that fraud or unfairness were not shown to have resulted . . . . [T]he incidence of a particular conflict of interest can seldom be measured with any degree of certainty . . . . Where an actual conflict of interest exists no more need be shown in this type of case to support a denial of compensation.<sup>117</sup>

In *Woods*, the Supreme Court emphasized the duties of creditors' committee members by referring to Judge Cardozo's opinion in *Meinhard v. Salmon*,<sup>118</sup> wherein Cardozo stated:

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden by those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.<sup>119</sup>

In another important case, *In re Johns-Manville Corp.*,<sup>120</sup> the bankruptcy court sanctioned an attorney who served as a member of a creditors' committee for continuing a pre-petition lawsuit against the debtor on behalf of his client without first securing relief from an automatic stay.<sup>121</sup> Stating that the interests of one claimant can diverge from the entire class of claimants, the court found that the attorney's actions in pursuing the lawsuit jeopardized his representation of other claimants.<sup>122</sup> The court enumerated the fiduciary duties

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115. *Id.* at 265-67.

116. Although *Woods* was decided under the Bankruptcy Act, the creditors' committee member's duties have not been altered by the Bankruptcy Code. See DeNatale, *supra* note 109, at 56-58.

117. *Woods*, 312 U.S. at 268.

118. 164 N.E. 545, 546 (1928).

119. *Id.* at 546.

120. 26 B.R. 919 (Bankr. S.D.N.Y. 1983).

121. *Id.*

122. *Id.* at 926. The court also stated, "[W]here a committee representative or agent seeks to represent or advance the interest of an individual member of a competing class of creditors or various interests or groups whose purposes and desires are dissimilar, this fiduciary is in breach of his duty of loyal and disinterested service." *Id.* at 925.

Courts have not tolerated conflicts of interests by members of creditors' committees. See *Woods v. City Nat'l Bank & Trust Co.*, 312 U.S. 262 (1941); *American United Mut. Life Ins., Co. v. City of Avon Park*, 311 U.S. 138 (1940); *Bohack Corp. v. Gulf W. Indus. Inc.*, 607 F.2d 258 (2d Cir. 1979); *In re Grant Broadcasting of Phila. Inc.*, 71 B.R. 655 (Bankr. E.D. Pa. 1987); *In re Penn-Dixie Indus., Inc.*, 9 B.R. 941 (Bankr. S.D.N.Y. 1981). But see *In re Plant Specialties, Inc.*, 59 B.R. 1 (Bankr. W.D. La. 1986) (approving the appointment of a representative of the debtor's competitor to the creditors' committee despite the debtor's objection that such an appointment would create an impermissible conflict of interest between the creditor's fiduciary duties to its constituent creditors and its individual self-interest).

of creditors' committee members as follows:

In the case of reorganization committees, these fiduciary duties are crucial because of the importance of committees. Reorganization committees are the primary negotiating bodies for the plan of reorganization. They represent those classes of creditors from which they are selected. They also provide supervision of the debtor and execute an oversight function in protecting their constituent's interests. . . . Accordingly, the individuals constituting a committee should be honest, loyal, trustworthy and without conflicting interests, and with undivided loyalty and allegiance to their constituents. . . . Conflicts of interest on the part of representative persons or committees are thus not be [sic] tolerated.<sup>123</sup>

The court specifically denounced the misappropriation of confidential information by committee members for their own private use. The court stated:

[committee members have] access to all sorts of confidential information regarding, *inter alia*, the details of proposed reorganization plans and the debtor-in-possession's operations . . . which information is not intended to be used in fostering the rights of private litigants outside the context of protecting these creditors as a group in these bankruptcy proceedings. This confidential position should not be so misused by [committee members]. Indeed, it may be viewed that in this regard, [the attorney] is using his fiduciary capacity to foster his own self interest as a private attorney, a breach of loyalty which is to be condemned.<sup>124</sup>

The context in which the above statement appeared in the court's opinion indicates that committee members who misappropriate corporate information for private use breach duties owed to the class they represent.<sup>125</sup>

The obligations and duties of creditors' committee members were further discussed in *In re Tucker Freight Lines, Inc.*<sup>126</sup> In *Tucker Freight*, an unsecured creditor sued individual members of the creditors' committee alleging that the members made false and misleading statements in the committee's letter to its constituents which recommended that the creditors reject the debtor's plan of reorganization.<sup>127</sup> The unsecured creditor charged that the committee members engaged in a "fraudulent scheme" in violation of their fiduciary

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123. *Johns-Manville*, 26 B.R. at 925 (citations omitted).

124. *Id.* at 926.

125. The court's opinion principally addressed obligations owed by committee members to their constituents.

126. 62 B.R. 213 (Bankr. W.D. Mich. 1986). Like *Woods*, *Tucker Freight* was decided under the Bankruptcy Code. See *supra* notes 114-119 (discussing *Woods*).

127. *Tucker Freight*, 62 B.R. at 215.

duties and the Exchange Act.<sup>128</sup> In response, the committee members asserted that under section 1103(c) of the Bankruptcy Code, committee members have absolute immunity for actions they took while serving on the committee.<sup>129</sup> Acknowledging that section 1103(c) may indeed include an implicit grant of limited immunity, the *Tucker* court nevertheless determined that section 1103(c) imposes a concurrent obligation which:

[a]t a minimum . . . requires that the committee's determinations must be honestly arrived at, and, to the greatest degree possible, also accurate and correct. For a Creditors' Committee to urge rejection of a plan for reasons they knew, or would have known but for their recklessness, to be false would violate this duty and deprive them of any limited immunity they might otherwise hold under Section 1103(c)(3).<sup>130</sup>

In addition to duties owed to their constituents, committee members may also have fiduciary duties to the committee itself and other committee members. For instance, in *SEC v. Baker*<sup>131</sup> the SEC charged that Sherman Baker breached fiduciary duties or other duties of trust or confidence to, *inter alia*, the creditors' committee.<sup>132</sup> The misappropriation of confidential information by a committee member would undoubtedly soil the reputation of the committee and reflect poorly on fellow committee members.<sup>133</sup> As a result, the misappropriation would harm the ability of the committee to function as a cohesive group, and disrupt the ability of the debtor and the committee to devise a plan of reorganization.

Members of creditors' committees who misappropriate material, nonpublic information in breach of their duties to their constituents, the committee and other committee members and who trade on that information, violate Rule 10b-5 under the misappropriation theory. The members would be liable regardless of whether they owed any duties to the shareholders of the traded securities.<sup>134</sup> Liability is pre-

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128. *Id.*

129. *Id.* at 216.

130. *Id.*

131. SEC. Reg. & L. Rep. (BNA) No. 25, at 1463 (Oct. 29, 1993). For a discussion of *Baker*, see *supra* notes 5-9 and accompanying text.

132. SEC's Complaint at 6, *SEC v. Baker*, No. 93 Civ. 7398 (RWS) (S.D.N.Y. filed Oct. 26, 1993); see *supra* notes 5-10 and accompanying text.

133. See *United States v. Newman*, 664 F.2d 12, 17 (2d Cir. 1981) ("By sullyng the reputations of [their] employers as safe repositories of client confidences, appellee and his cohorts defrauded their employers as surely as if they took their money."), *cert. denied*, 464 U.S. 863 (1983).

134. See *id.*

mised on the fact that there is a relationship of trust and confidence between the committee members and their constituents, the committee itself and the other committee members.<sup>135</sup> Trading on confidential information received as a result of membership on the committee exploits the relationship of trust and confidence. As the district court observed in *SEC. v. Tome*:<sup>136</sup>

The common-sense notion underlying the misappropriation theory is that one who misappropriates valuable information for his own benefit, in breach of a fiduciary or similar duty of trust and confidence, has surely committed fraud on the person or entity to whom that duty is owed.<sup>137</sup>

In *Tome*, as well as in other cases that have adopted the misappropriation theory,<sup>138</sup> the wrongdoer was found to have breached the duty of confidentiality owed to the source of the information. However, this breach is not the only circumstance when liability may be imposed under the misappropriation theory. Liability may also be imposed when, as in the case of committee members, persons owe duties of confidentiality, as a result of their status or employment, to someone other than the source of the information. As observed by the court in *SEC v. Musella*,<sup>139</sup> "*Newman* gave legal effect to the commonsensical view that trading on the basis of improperly obtained information is fundamentally unfair, and that distinctions premised on the *source* of the information undermine the prophylactic intent of the securities laws."<sup>140</sup>

In *SEC v. Materia*<sup>141</sup> an employee of a financial printer misappropriated and traded on confidential information regarding proposed tender offers by the printer's corporate clients. The court found that the employee had breached a duty to and committed a fraud upon its employer, the printing firm, even though the source of the confidential information was the printer's corporate clients.

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135. As temporary insiders, committee members may also have a relationship of trust and confidence with the debtor corporation. See *infra* note 223 and accompanying text. This relationship may arise out of an expressed confidentiality agreement or may otherwise be established by the nature of the dealings between the committee and the corporation. See *infra* notes 225-26 and accompanying text. Exploitation of that relationship may also be grounds for finding a violation of Rule 10b-5 under the misappropriation theory. See *infra* notes 263-64 and accompanying text.

136. 638 F.Supp. 596 (S.D.N.Y. 1986).

137. *Id.* at 599.

138. See, e.g., *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990); *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y.) *rev'd on other grounds*, 773 F.2d 447 (2d Cir. 1985).

139. 578 F. Supp. 425, 438 (S.D.N.Y. 1984).

140. *Id.* (emphasis added).

141. 745 F.2d 197 (2d Cir. 1984).



Likewise, in *Newman*<sup>142</sup> confidential tender offer information had been entrusted to the investment banking firm's corporate clients. The employees of the investment banking firms and their accomplices who traded on the information were found to have breached confidences and defrauded the investment banking firms, as well as the corporate clients.<sup>143</sup> In addition, in *Carpenter*,<sup>144</sup> the Supreme Court left undisturbed the conviction of Winans and his accomplices who traded on information contained in Winans' upcoming column even though the party to whom Winans owed a fiduciary duty, the Wall Street Journal, did not provide or impart confidential information to him.<sup>145</sup>

## 2. *Creditor Steering Committees*

Since creditor steering committees are formed by agreement rather than statute, some commentators have suggested that members of steering committees do not have fiduciary duties to their constituent class (holders of the same class of securities that are not members of the steering committee).<sup>146</sup> Prior to the passage of the Bankruptcy Code, the formation and governance of creditors' committees was not dictated by statute. Nevertheless, pre-Code creditors' committee members were found to be fiduciaries to their constituent class.<sup>147</sup> By analogy, it can be argued that creditor steering

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142. 664 F.2d 12 (2d Cir. 1981) *cert. denied*, 464 U.S. 863 (1983).

143. *Id.* at 15.

144. 484 U.S. 19 (1987).

145. *Id.* at 28.

146. *See, e.g.,* Brodsky et al., *supra* note 34 at 601, ("Committee members, as creditors of the company, do not have a fiduciary duty to the company and do not assume one merely by entering into negotiations . . . [T]emporary insider status as to such information [as emanating from the company] should not automatically apply to information generated by the committee itself.") The authors posture that "where it is understood by bondholders at large that steering committee members are returning their freedom to trade, committee members should not be construed as assuming a fiduciary duty to disclose their positions before trading." *Id.* Similarly, the authors contend that "information about negotiating positions of other creditors of the company should not be inside information . . . absent an undertaking to keep the information confidential. *Id.*"

147. *See* *Young v. Higbee*, 324 U.S. 204, 210 (1945) (finding that members of a reorganization committee had a fiduciary duty to all members in their class of stock; "at the very least they owed them an obligation to act in good faith"); *see also In re Cosgrove-Meehan Coal Corp.*, 136 F.2d 3 (3d Cir. 1943). In *Cosgrove-Meehan*, the Third Circuit upheld the trial court's denial of a compensation and reimbursement claim by a member of the pre- and post-petition bondholder's committee that during the pre-petition phase traded in the debtor's bonds. *Id.* at 6. The court concluded that the committee member served as a fiduciary during both phases, stating:

[The committee member] makes no attempt to sever his services as a committee member prior to the reorganization proceeding from the services performed by him in like capacity after the institution of that proceeding. Nor can we perceive how he

committee members act as fiduciaries to their constituent class.

There is some question, however, as to whether steering committee members act for the interests of their constituent class, or simply for their own interests. Steering committee members often own significant amounts of the issuer's securities, and act collectively to gain greater influence with the financially troubled firm. Whether members represent only themselves or other bondholders in negotiations with the distressed company depends upon the understanding of the parties. Since their actions have consequences for similarly situated creditors, the distressed company may regard the creditor steering committee as representing the interests of their constituent class, or at the very least, serving the "interests of their constituent [class] by serving their own self-interest."<sup>148</sup> However, since steering committees are by definition formed before the issuer has filed for bankruptcy, the imprimatur of acting for others is not formally present; nor is the number and identity of other bondholders necessarily discernable.

Whether or not steering committee members have fiduciary duties to their constituent class may best be determined on a case-by-case basis based on the understanding of the parties. If the committee purports to act for other bondholders, its members may be bound by the representation and regarded as fiduciaries of those security holders. Accordingly, they may breach duties of trust and confidence or other fiduciary duties to other bondholders if they trade while in possession of material, nonpublic information obtained through participation on the committee. However, if the steering committee portrays itself as acting only for the interests of each committee member, acts accordingly, and is regarded by the distressed entity as representing only its own interests, the committee members should not be characterized as owing fiduciary duties to their constituent class. In an attempt to define their role, some steering committees have disclaimed any fiduciary role in their charter.<sup>149</sup>

Since most bondholders would be disinclined to limit their ability to trade the securities of a financially troubled entity, few steering committee members would characterize themselves as acting for the

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could make any such severance. The character of his fiduciary relation as a committee member was a continuing status of identic quality throughout, regardless of when the reorganization proceeding was instituted.

*Id.* at 5.

148. Brodsky et al., *supra* note 34, at 594.

149. Wolfson et al., *supra* note 13, at 193.

interests of others. In the case of a "pre-packaged" Chapter 11 plan,<sup>150</sup> the failure of the steering committee members to act as fiduciaries for their constituent class could hamper or impede the court's approval of the plan, since unrepresented bondholders could claim that the plan does not adequately protect their interests.<sup>151</sup> To avoid that predicament, financially distressed companies could require that the creditors' steering committee affirmatively represent that they act for their constituent class as a condition to being recognized.

Should the steering committee represent that it acts for its constituent class to gain greater influence with the financially troubled entity or if required by the financially distressed company as a requisite to being recognized, the committee should be regarded as owing duties of trust and confidence or other fiduciary duties to their constituent class.

### *B. Breach of Fiduciary Duties Owed By Creditors' Committee Members to the Insolvent Corporation and Its Shareholders*

In addition to breaching fiduciary duties owed to their constituents, the committee itself and to other committee members, members of creditors' committees who purchase or sell securities of the insolvent corporation while in possession of material, nonpublic information breach duties owed to the insolvent corporation and its related parties. Historically, courts have held that creditors' committee members do not owe duties to the insolvent corporation. Nevertheless, members of creditors' committees who are provided confidential information as a consequence of their committee position may be regarded as "temporary insiders." In an amicus curie brief<sup>152</sup> filed in the bankruptcy reorganization proceedings involving

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150. In a pre-packaged plan, the company (the prospective debtor) negotiates and solicits acceptance of a reorganization plan prior to filing a bankruptcy petition under Chapter 11.

151. Wolfson et al., *supra* note 13, at 194.

152. Brief of the SEC, *In re Federated Dep't Stores Inc.*, No. 1-90-00130, 1991 WL 79143 (Bankr. S.D. Ohio January 18, 1991). On January 18, 1991, the SEC filed an amicus brief in support of the motion by Fidelity Management & Research Co. ("Fidelity") for an order determining that Fidelity would not violate its fiduciary duties as a member of the Allied's official bondholders' committee if it traded in the securities of the debtor, provided that Fidelity implemented "information blocking devices" (also referred to as "Chinese Walls") to prevent the communication of inside information between Fidelity's committee representatives and investment personnel. The U.S. Bankruptcy Court for the Southern District of Ohio granted Fidelity's motion and specified that his ruling was confined to committee members who are "engaged in the trading of securities as a regular part of their business." *Federated Department Stores*, at \*2, No. 1-90-

Allied Stores Corp. and Federated Department Stores, Inc.,<sup>153</sup> the SEC advised that "in a bankruptcy context, the members of an official committee are properly viewed as 'temporary insiders' of the debtor."<sup>154</sup> As such, committee members are subject "to the same insider trading restrictions as true insiders such as corporate directors."<sup>155</sup> As "true insiders" they have an obligation to disclose material, nonpublic information to shareholders or abstain from trading on that information.

### 1. *Adverse Interests*

Traditionally, courts have ruled that a creditors' committee and its members owe no duty to the debtor or to the debtor's estate.<sup>156</sup> For example, in *In re Johns-Manville Corp.*,<sup>157</sup> the court, while analyzing the obligations of members of an equity committee, generally noted the duties of bankruptcy committee members, stating:

No doubt, a committee and its members are fiduciaries for each of the parties that it represents. . . . But neither a committee nor its members has any underlying duty to the debtor or to the estate. Rather, a committee's only duty is to pursue the interests of its members. That pursuit, together with the representation of other committees, collectively furthers the reorganization process.<sup>158</sup>

Additionally, the Bankruptcy Court, in *In re Microboard Processing, Inc.*,<sup>159</sup> concluded that a creditors' committee and its members have a fiduciary duty only to those represented by the committee.<sup>160</sup> In that case, the debtor sought removal of the two largest unsecured creditors from the creditors' committee since their claims were the only claims disputed by the debtor and were disproportionate to all other unsecured debt.<sup>161</sup> The court found that the unwillingness of the two unsecured creditors to negotiate with the

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00130, 1991 WL 79143 (Bankr. S.D. Ohio March 7, 1991) (Order Permitting Securities Trading in Certain Circumstances). See generally Robert C. Pozen & Judy K. Mencher, Chinese Walls for Creditors' Committees, 48 BUS. LAW. 747 (1993).

153. *Federated Department Stores*, No. 1-90-00130, 1992 Bankr. LEXIS 392 (Bankr. S.D. Ohio Nov. 20, 1992).

154. Brief of the SEC, at 5.

155. *Id.*

156. See, e.g., *Bohack Corp. v. Gulf W. Indus. Inc.*, 607 F.2d 258, 262 n.4 (2d Cir. 1979).

157. 60 B.R. 842 (Bankr. S.D.N.Y. 1986).

158. *Id.* at 853-54 n.23.

159. 95 B.R. 283 (Bankr. D. Conn. 1989).

160. *Id.* at 285.

161. *Id.*

debtor did not constitute grounds for removal.<sup>162</sup> Additionally, the court found that a fiduciary duty owed by the committee and its members to the estate would interfere with the duty owed to other constituents.<sup>163</sup> A member of a creditors' committee that has significant contacts with the debtor as an insider may be removed from the committee.<sup>164</sup> The reasoning employed to remove the debtor-insider highlights the adverse relationship between the debtor and the committee. In *In re Swolsky*,<sup>165</sup> the Bankruptcy Court for the Northern District of Ohio removed from a creditors' committee a member whose wife was the office manager, bookkeeper, and vice-president of the debtor.<sup>166</sup> The court stressed the risks to confidentiality of communication among committee members and concluded that the presence on the committee of either the debtor or his agent would have a "chilling effect on the other members."<sup>167</sup>

The refusal by the above courts to recognize a fiduciary duty on

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162. *Id.* at 286. The court further stated:

The creditors' committee is not merely a conduit through whom the debtor speaks to and negotiates with creditors generally. On the contrary, it is purposely intended to represent the necessarily different interests and concerns of the creditors it represents. It must necessarily be adversarial in a sense, though its relation with the debtor may be supportive and friendly.

*Id.* (quoting *In re Daig Corp.*, 17 B.R. 41, 43 (Bankr. D. Minn. 1981)).

163. *Id.*

164. *In re Penn-Dixie Indus., Inc.*, 9 B.R. 941, 944-45 (Bankr. S.D.N.Y. 1981) (allowing the removal from the committee of an appointee to the equity committee who also sat on the board of directors of the debtor); see also *In re Johns-Manville Corp.*, 26 B.R. 919, 925-926 (S.D.N.Y. 1983) (stating that individuals constituting a reorganization committee should be honest, loyal, trustworthy and without conflicting interests and with undivided loyalty and allegiance to their constituents); *In re Glendale Woods Apartments, Ltd.*, 25 B.R. 414, 415 (Bankr. D. Md. 1982) (removing creditors for conflict of interests where one creditor's claim was part of agreement to guarantee debtor's repayment of money owed to the debtor's partners and other creditor's claim was one personally owed by debtor's managing partner); *Daig Corp.*, 17 B.R. at 42 (removing creditor as member of committee where its representative and principal operating officer was father of chairman of the debtor). Although the Code does not specifically exclude insiders from committee membership, Bankruptcy Rule 1007(d) excludes insiders from the debtor's list of 20 largest creditors. 11 U.S.C. § 1007(d)(1988).

165. 55 B.R. 144 (Bankr. N.D. Ohio 1985).

166. *Id.* at 144.

167. *Id.* at 146. But see *In re Nyack Autopartstores Holding Co.*, 98 B.R. 659 (S.D.N.Y. 1989) (refusing to revoke a Chapter 11 confirmation order because complaint did not particularize any fraudulent conduct on part of corporate debtors even though the committee chairman was a cousin of the debtor's principal operating officer); *In re Vermont Real Estate Invest. Trust*, 20 B.R. 33 (Bankr. D. Vt. 1982) (refusing to deny committee membership to the wife of the former executive officer of the debtor who was also a co-defendant with her husband in a lawsuit alleging fraudulent involvement in certain of the debtor's prior activities. However, the court required her to refrain from participating in any committee discussions regarding her lawsuit against the debtor).

the part of the committee or its members to the debtor does not thwart the application of the temporary insider theory. None of the above decisions concerned the issue of trading on inside information. The decisions focused instead on the obligations of committee members to their constituents and other members of the committee. Those obligations were found to be inconsistent with owing any duties to the debtor. Further, courts have recognized that a confidential relationship may exist between two parties operating at arms length.<sup>168</sup> The *circumstances* of the relationship between an outsider and the corporation are more important than initial assumptions concerning the outsider's position in relation to the corporation.<sup>169</sup>

## 2. Temporary Insiders

### a. *In re Cady, Roberts & Co.*<sup>170</sup>

Traditional corporate insiders include officers, directors and controlling shareholders. However, the Commission in *In re Cady, Roberts & Co.*<sup>171</sup> stated that these three groups "do not exhaust the class of persons upon whom there is such an obligation."<sup>172</sup> Rather, the Commission held that the obligation to disclose material, non-public information to shareholders or to abstain from trading requires:

the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose . . . and the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.<sup>173</sup>

### b. *Dirks v. SEC*, Footnote 14

At Footnote 14 of its opinion in *Dirks v. SEC*,<sup>174</sup> the Supreme

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168. See *Smith v. Dravo*, 203 F.2d 369 (7th Cir. 1953). For a discussion of *Smith*, see *infra* notes 216-20 and accompanying text.

169. See *SEC v. Lund*, 570 F. Supp. 1397 (C.D. Cal. 1983). For a discussion of *Lund*, see *infra* notes 179-87 and accompanying text.

170. 40 S.E.C. 907 (1967).

171. *Id.*

172. *Id.* at 912.

173. *Id.* (stating that the scope of the disclose or abstain rule is not "circumscribed by fine distinctions and rigid classifications." Rather, the prohibition against insider trading is directed at "those persons who are in a special relationship with the company and privy to its internal affairs").

174. 463 U.S. 646 (1983).

Court recognized the existence of "temporary insiders."<sup>175</sup> The Court stated that individuals who have a special confidential relationship with the corporate issuer or insider, and who are given information for legitimate corporate purposes with the expectation that such information be kept confidential and used only for legitimate corporate purposes, may be characterized as "temporary insiders."<sup>176</sup> The Court added: "for such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed non-public information confidential, and the relationship must at least imply such a duty."<sup>177</sup> Footnote 14 specifies certain persons that may be determined to be temporary insiders, namely underwriters, accountants, lawyers and consultants, but the language in footnote 14 does not limit the application of the doctrine to those persons.<sup>178</sup>

c. Judicial Interpretation of Footnote 14

In the first case to apply footnote 14 of *Dirks*, the court in *SEC v. Lund*<sup>179</sup> determined that the circumstances of a relationship may imply an obligation to keep certain information confidential. In that case, Horowitz, the Chief Executive Officer and President of P&F Industries, Inc. ("P&F"), told Lund, a long-time friend and a director of Verit Industries ("Verit"), about negotiations between P&F and another entity concerning a joint venture and asked if Verit would be interested in providing a capital investment for the venture.<sup>180</sup> After the conversation, Lund purchased P&F securities, his only purchase of P&F securities in ten years.<sup>181</sup>

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175. In footnote 14, the Court notes,

Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee. For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed non-public information confidential, and the relationship must at least imply such a duty.

*Id.* at 655 n.14 (citations omitted).

176. *Id.*

177. *Id.*

178. *Id.*

179. 570 F. Supp. 1397 (C.D. Cal. 1983).

180. *Id.* at 1400.

181. *Id.*

The district court found that Lund violated section 10(b) and Rule 10b-5.<sup>182</sup> The Court determined that Lund was a temporary P&F insider when he traded on the basis of the information concerning the proposed joint venture.<sup>183</sup> The court underscored the special relationship between Horowitz and Lund, noting that they were long-time friends who had often exchanged private corporate information,<sup>184</sup> and concluded that Horowitz told Lund about the joint venture because of this special relationship.<sup>185</sup> The court further found that the relationship between Horowitz and Lund was such as to imply that the information was to be kept confidential.<sup>186</sup> The court concluded, "[u]nder these circumstances, Lund became a temporary P&F insider upon receipt of the information concerning the [joint venture] and assumed an insider's duty to 'disclose or abstain' from trading based on that information."<sup>187</sup>

Following *Lund*, other courts have recognized as temporary insiders a number of individuals with close affinity to the issuer or corporate insiders.<sup>188</sup> In *SEC v. Gaspar*,<sup>189</sup> Gaspar, an employee of a brokerage firm, represented Dyson-Kisser-Moran's Corp. ("DKM") regarding acquisition by DKM of the holdings of Emory Clark and his family in Clark Oil and Refining Corp ("Clark Oil").<sup>190</sup> In connection with his representation of DKM, Gaspar learned of DKM's interest in making a tender offer for Clark Oil's outstanding shares, and tipped the information to a friend.<sup>191</sup>

The trial court found that Gaspar owed fiduciary duties of hon-

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182. *Id.* at 1403.

183. *Id.*

184. *Id.*

185. *Id.* ("The information was made available to Lund solely for corporate purposes. It was not disclosed in idle conversation or for some other purpose.").

186. *Id.* ("Horowitz clearly did not expect Lund to make the information public or to use the information for his personal gain. Lund knew or should have known that the information he received was confidential and that it had been disclosed to him solely for legitimate corporate purposes.").

187. *Id.* (emphasis added).

188. See *SEC v. Musella*, 578 F. Supp. 425, 439-40 (S.D. N.Y. 1984) (characterizing manager of a law firm's office services department as a temporary insider); see also *United States v. Victor Teicher & Co., L.P.*, 785 F. Supp. 1137 (S.D.N.Y. 1992) (applying temporary insider status to member of investment firm that had access to "phantom list" containing the names of the companies that firm was not to trade in because of firm's involvement in transactions relating to them), *aff'd*, 987 F.2d 112 (2d Cir. 1993), *cert. denied*, 114 S. Ct. 467 (1993).

189. [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,004, at 90,967 (S.D.N.Y. Apr. 15, 1985).

190. *Id.* at 90,969.

191. *Id.* at 90,975.



esty and loyalty to the brokerage firm.<sup>192</sup> Furthermore, since Gaspar represented DKM on behalf of the brokerage firm during the course of DKM's secret negotiations with Emory Clark, the court concluded that Gaspar was a "temporary insider" of DKM with a fiduciary duty to that corporation.<sup>193</sup> Quoting *Dirks*, the court stated that under certain circumstances, outsiders may become fiduciaries: "[t]he basis for recognizing this fiduciary duty is not simply that they acquired nonpublic information, but rather that they have entered into a special relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes."<sup>194</sup>

Additionally, in *SEC v. Tome*,<sup>195</sup> an informal, financial consultant to Joseph E. Seagram & Co. ("Seagram") learned from the chief executive officer that Seagram intended to announce a hostile tender offer for St. Joe Minerals Corp. and traded on the information.<sup>196</sup> The court noted that "[t]he relationship between the management of a corporation and its financial advisors and consultants regarding prospective hostile tender offers is inherently one which implies a duty of confidentiality."<sup>197</sup> Thus, even though Tome was not a corporate officer or director, he was found to have owed a fiduciary duty to Seagram with respect to the information.<sup>198</sup>

Three years before the Supreme Court espoused the temporary insider doctrine in *Dirks*, the Second Circuit in *Walton v. Morgan Stanley & Co., Inc.*<sup>199</sup> declined to recognize a duty of confidentiality absent prescribed duties and obligations concerning the receipt of confidential information.<sup>200</sup> In *Walton*, Morgan Stanley, an investment banking and financial advisory firm, was retained by Kennecott Copper Corp. ("Kennecott") to find a company that Kennecott could acquire.<sup>201</sup> One of the companies it considered acquiring, Olinkraft, cooperated with Morgan Stanley by providing confiden-

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192. *Id.* at 90,978.

193. *Id.*

194. (quoting *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983)).

195. 638 F. Supp. 596 (S.D.N.Y. 1986).

196. *Id.* at 599.

197. *Id.* at 621.

198. *Id.* at 622; see also *SEC v. Downe*, No. 92 Civ. 4092, 1993 WL 22126 (S.D.N.Y. Jan. 26, 1993)(characterizing the head of an investor group seeking to gain control of Bally Manufacturing Co. as a "confidential adviser" to Bally and found to be a "temporary insider").

199. 623 F.2d 796 (2d Cir. 1980).

200. *Id.* at 799.

201. *Id.* at 797.

tial internal earnings projections and instructed that the nonpublic information was to be used in connection with the Kennecott bid and was to be returned to Olinkraft if such bid did not occur.<sup>202</sup> A year after Kennecott's acquisition plans were abandoned, Texas Eastern Corp. made a bid to acquire Kennecott.<sup>203</sup> After the announcement, Morgan Stanley purchased a substantial amount of Olinkraft stock. Following the purchases, Morgan Stanley shared the confidential information it had received with Johns-Manville, an entity it was advising, to encourage Johns-Manville to make a substantially higher offer than made by Texas Eastern Corp.<sup>204</sup>

Morgan Stanley denied having a fiduciary relationship with Olinkraft.<sup>205</sup> The Second Circuit sided with Morgan Stanley, noting that Morgan Stanley's client was Kennecott, not Olinkraft.<sup>206</sup> The court determined that Morgan Stanley had no duty to act on Olinkraft's behalf.<sup>207</sup> Furthermore, the court refused to embrace Olinkraft's argument that Morgan Stanley became a fiduciary of Olinkraft by virtue of the receipt of the confidential information:

[t]he fact that the information was confidential did nothing, in and of itself, to change the relationship between Morgan Stanley and Olinkraft's management. Put bluntly, although, according to the complaint, Olinkraft's management placed its confidence in Morgan Stanley not to disclose the information, Morgan Stanley owed no duty to observe that confidence.<sup>208</sup>

Unlike the court in *Lund*,<sup>209</sup> the court in *Walton* did not consider the circumstances of the relationship between Morgan Stanley and Olinkraft. The court did recognize the predicament faced by Olinkraft, a potential target which may have been required by its responsibility to the shareholders to disclose confidential information to a potential acquiror.<sup>210</sup> However, instead of recognizing that Morgan Stanley could have an implied duty of confidentiality to Olinkraft, the court only identified the duty to the legally-retained client. The court concluded that the relationship between Morgan Stanley and Olinkraft was adverse and incapable of supporting a

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202. *Id.*

203. *Id.*

204. *Id.*

205. *Id.* at 789.

206. *Id.*

207. *Id.* at 798 ("Morgan Stanley and Olinkraft's management must be presumed to have dealt, absent evidence of an extraordinary relationship, at arm's length.").

208. *Id.* at 799.

209. 570 F. Supp. 1397 (C.D. Cal. 1983).

210. *Walton*, 623 F.2d at 799.

claim of a fiduciary relationship.<sup>211</sup>

The court noted the absence of an agreement or understanding concerning the confidentiality of information provided to Morgan Stanley.<sup>212</sup> It is unclear from the court's opinion, however, whether a clear agreement or understanding concerning the confidential financial information would have made Morgan Stanley's trading actionable.<sup>213</sup>

In his dissenting opinion, Judge Oakes contended that Morgan Stanley's acceptance of the information on confidential terms created an implied obligation to respect the confidentiality of the information.<sup>214</sup> Judge Oakes explained that, although Morgan Stanley did not owe a duty to Olinkraft or its shareholders when it first approached Olinkraft, once Olinkraft began to cooperate in the deal by turning over confidential financial information, "the acceptance of such information by Morgan Stanley, *on the confidential terms*, along with its understood role as intermediary in a cooperative takeover, imposed a duty on the investment banker under well-established common law principles not to use that information for its own profit."<sup>215</sup>

Unlike the decision in *Walton*, the court in *Smith v. Dravo Corp.*<sup>216</sup> determined that a confidential relationship existed between two parties engaged in an arm's length transaction. In that case, Smith, a builder of shipping containers, provided detailed confidential information concerning its business operations to Dravo. After the two parties failed to agree on a sale price, negotiations between the two companies were terminated. Dravo then constructed its own shipping containers that were very similar to Smith's. Although Dravo made no express promise to preserve the confidentiality of the information,<sup>217</sup> the court, nonetheless, found a promise of confidenti-

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211. *Id.*

212. *Id.* ("But that obligation, while it burdens management, which might therefore reasonably insist upon an agreement of confidentiality, does not change the relationship between the target and the acquiror or its advisor. Appellants' complaint alleges no such agreement or understanding.").

213. Normally, creditors' committees execute a confidentiality agreement prior to receiving confidential information from the debtor.

214. *Walton*, 623 F.2d at 801 (Oakes, J. dissenting)(emphasis in original); see Gregory R. Andre, Note, *Constructive Insider Liability and the Arm's Length Transaction Under Footnote Fourteen of Dirks*, 52 GEO. WASH. L. REV. 872, 884 (1984).

215. *Walton*, 623 F.2d at 801.

216. 203 F.2d 369 (7th Cir. 1953).

217. *Id.* at 376.

ality implied from the relationship of the parties.<sup>218</sup> The court noted that the information was provided for "one purpose, to enable defendant to appraise it with a view in mind of purchasing the business. Trust was reposed in it by plaintiffs that the information thus transmitted would be accepted subject to the limitation."<sup>219</sup> The court was unswayed by the arm's-length nature of the transaction stating, "the implied limitation on the use to be made of the information had its roots in the 'arm's-length' transaction."<sup>220</sup>

The impact of *Walton* on the question of the liability of creditors committee members is dubious. Had *Walton* been decided using the analysis outlined in *Dirks*, the court could have found an implied duty of confidentiality, and thus, treated Morgan Stanley as a temporary insider. First, the corporation expected and specifically requested Morgan Stanley to keep the information confidential. Second, Morgan Stanley's conduct in accepting the information and not divulging it or acting upon it during the course of the negotiations, at least suggests that some type of confidential relationship exist.<sup>221</sup>

Moreover, the relationship between creditors' committee members and the debtor corporation is different from that of Morgan Stanley and Olinkraft. Creditors committee members and the debtor corporation have a relationship prior to and in addition to the disclosure of the confidential information. In contrast, Morgan Stanley and Olinkraft's only association was the disclosure of the confidential information. The relationship between the creditors' committee members and the corporation is more akin to the relationship in *Lund*.

### 3. Application of Footnote 14

#### a. Official Creditors' Committee

*Dirks* specified a two-part test for determining when an outsider may be characterized as a temporary insider: first, the existence of "a special confidential relationship in the conduct of the business of the enterprise" in which the outsider is "given access to information solely for corporate purposes;" and second, "the corporation must expect the outsider to keep the nonpublic information confidential and the relationship must imply such a duty."<sup>222</sup>

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218. *Id.*

219. *Id.*

220. *Id.* at 377.

221. See Andre, *supra* note 214, at 884.

222. 463 U.S. 646, 655 n.14 (1983); see *supra* texts accompanying notes 174-78.

The debtor and the creditors' committee enter into a "special confidential relationship" to facilitate the reorganization of the debtor corporation. To achieve this objective, committee members are given access to confidential information. Committee members receive the information as a consequence of their expansive investigative powers.<sup>223</sup> The power of creditors' committees to fully investigate the debtor and its business affairs is defined by the Bankruptcy Code and is judicially recognized.<sup>224</sup>

Also, the debtor expects creditors' committee members to keep the information confidential and the relationship implies such a duty. Generally, committee members are required to sign confidentiality agreements as a condition to receiving confidential corporate information.<sup>225</sup> Under the agreements, the debtor's intent to keep the information confidential is clear. However, even when a debtor does not require committee members to execute confidentiality agreements, the receipt alone of confidential information carries with it the obligation that the information be kept confidential.<sup>226</sup> Moreover, the use of the confidential information for personal gain is an apparent abuse of the confidence.

## b. Creditor Steering Committees

Unlike official creditors' committees, which are specifically authorized to investigate the financial affairs of the debtor,<sup>227</sup> creditor steering committees have no defined right to receive or review confidential information concerning the financial affairs of the financially troubled company. Nevertheless, members of creditor steering committees, like official creditors' committees, appear to come within the temporary insider definition articulated in *Dirks*<sup>228</sup> — individuals who have a special confidential relationship with the corporate

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223. See *supra* notes 21-24 and accompanying text.

224. See *supra* notes 21-24 and accompanying text.

225. See Wolfson et al., *supra* note 13, at 186.

226. See *supra* note 217 and accompanying text; see also Andre, *supra* note 214, at 885 ("Footnote 14 of *Dirks* does not call for an express bi-lateral agreement, but states that the terms of the relationship must imply a duty to maintain confidentiality. The footnote focuses concern on the expectations of the insider, not the outsider, and looks to whether a duty can be implied, not where the outsider expressly agreed to be bound.") (citations omitted.)

227. See 11 U.S.C. § 1103(c)(2) (1988) (detailing member responsibilities and committees established under 11 U.S.C. § 1102, the section entitled "Creditors and Equity Security Holders Committees").

228. *Dirks v. S.E.C.*, 463 U.S. 646 (1983). For a discussion of *Dirks*, see *supra* notes 174-78 and accompanying text.

issuer or insider and who are given information for legitimate corporate purposes with the expectation that such information be kept confidential and used only for legitimate corporate purposes.<sup>229</sup>

Providing confidential information to a creditor steering committee does not alone establish a relationship of trust and confidence between the distressed entity and the members of the committee.<sup>230</sup> However, the primary reason that a distressed entity would provide a creditor steering committee with confidential corporate information would be to further the interests of the entity, such as to apprise creditors of inadequate cash flow in hopes of modifying the terms of indenture agreement or other obligations. Those circumstances suggest the existence of a special relationship of trust and confidence.<sup>231</sup> Although the reasoning is admittedly circular, steering committee members would be hard pressed to deny the existence of a special confidential relationship where they alone received confidential information. Moreover, the existence of a confidentiality agreement would likely fortify the contention that a special confidential relationship existed between the distressed entity and the steering committee.

#### 4. *Application of the Misappropriation Theory*

Members of official and unofficial creditors' committees who are determined to owe fiduciary duties to the insolvent corporation may be liable for trading on material, nonpublic information either as insiders, under the temporary insider theory, or under the misappropriation theory. Both the temporary insider theory and the misappropriation theory are premised on the existence of a relationship of trust and confidence between the outsider and the corporation.<sup>232</sup> Members of creditors' committees who misappropriate material, nonpublic information received from the corporation, or as a result

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229. *Dirks*, 463 U.S. at 660.

230. See *SEC v. Ingram*, 694 F. Supp. 1437, 1440 (C.D. Cal. 1988) (holding that an expectation of confidentiality does not in itself, create a fiduciary relationship). "[T]here must be some sort of special relationship from which an objective person would conclude that a confidential relationship exists." *Id.*

231. See *SEC v. Gaspar*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,004, at 90,978 (S.D.N.Y. Apr. 15, 1985) (finding a "special relationship" and fiduciary duty where persons are given access to information solely for corporate purposes).

232. Barbara Rudolf, Note, *Subjective Evaluations of Technology as Bases for Rule 10b-5 Securities Law Violations: Liability for Scientific Consultants*, 61 GEO. WASH. L. REV. 1856, 1884 ("there is no practical difference between the [temporary insider and the misappropriation] theories where the duty owed by the outsider runs to the issuing corporation.").

of their membership on the committee, and who trade on the information exploit the trust and confidence of the corporation. Consequently, they breach a duty to the corporation and may be liable under Rule 10b-5.

### C. *Liability of Committee Members for Trading in Debt Securities*

As temporary insiders of the insolvent corporation, members of creditors' committees owe fiduciary duties to the corporation's shareholders. Committee members who trade in the *equity* securities of the debtor corporation while in possession of inside information breach duties owed to shareholders. Traditionally, however, neither the issuer nor its insiders have owed fiduciary duties to debtholders. By its language, footnote 14 of *Dirks* is limited to explaining how "outsiders may become fiduciaries of the shareholders."<sup>233</sup>

At first glance, trading by committee members in the *debt* securities of the debtor would not be actionable because committee members breach no duties to shareholders as a result of the trading. Liability may, however, be premised on: (1) the ruling in *Pepper v. Litton*<sup>234</sup> which expands the insider's duties to creditors when the corporation is insolvent; and (2) the misappropriation theory and breach of duties owed to the corporation.

#### 1. *Traditional View*

Corporations and their insiders traditionally have been found to owe no fiduciary duties to the holders of the corporation's debt securities.<sup>235</sup> Under corporate law, the rights of bondholders are gov-

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233. 463 U.S. at 655 n.14.

234. 308 U.S. 295 (1939).

235. See *Simons v. Cogan*, 542 A.2d 785, 786 (Del. Ch. 1987) (noting that "[i]t has now become firmly fixed in our law" that insiders do not owe the corporation's bondholders any "duty of the broad and exacting nature characterized as a fiduciary duty"), *aff'd*, 549 A.2d 300 (Del. 1988); *Lorenz v. CSX Corp.* [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,689, at 97,204 (3d. Cir. Aug. 6, 1993) (stating that "It is well-established that a corporation does not have a fiduciary relationship with its debt security holders, as with its shareholders. The relationship between a corporation and its debtholders is contractual in nature"). But see *SEC v. Karcher*, Litigation Release No. 11,702, 40 SEC 950 (C.D. Cal. Apr. 14, 1988) (ruling that a fast food restaurant executive violated section 10(b) and Rule 10b-5 when he sold his company's debentures before disclosing negative earnings). Although the court's ruling logically requires a finding that the executive owed a fiduciary obligation to the purchasers of the debentures, the issue was never explicitly addressed by the parties or the court. *Id.*; see *Pitt & Groskaufmanis*, *supra* note 68, at

earned exclusively by the terms of the bond contract.<sup>236</sup> In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,<sup>237</sup> the Delaware Supreme Court determined that the Revlon directors breached a duty of loyalty to their shareholders by entering into a lock-up agreement that favored debtholders at the expense of shareholders.<sup>238</sup> The court reasoned that, unlike equity holders, the rights of the debtholders were merely contractual — governed by the indenture.<sup>239</sup>

The lack of a fiduciary relationship between an issuer and its debtholders was also determinative in *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*<sup>240</sup> In that case, bondholders brought action against RJR Nabisco ("RJR") to recover the loss of value of the corporation's bonds following a leveraged buyout.<sup>241</sup> RJR countered by arguing that the express provisions of the bond indentures permitted mergers and the incurrence of additional debt.<sup>242</sup> Concluding that the company and its bondholders "do not stand in a fiduciary relationship with one another,"<sup>243</sup> the district court restricted its analysis to contract law and ruled in favor of RJR.<sup>244</sup>

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236-37.

236. *Mann v. Oppenheimer & Co.*, 517 A.2d 1056, 1061 (Del. 1986) ("The rights of debenture holders are controlled by the terms of the indenture under which the securities are issued."); *Lorenz*, at 97,204.

237. 506 A.2d 173 (Del. 1986).

238. *Id.* at 179 (referring to waiver of the notes causing decrease in value).

239. *Id.* at 182 (citing *Wolfensohn v. Madison Fund, Inc.*, 253 A.2d 72, 75 (Del. 1969)); see also *Harff v. Kerkorian*, 324 A.2d 215 (Del. 1974) (finding that the holders of convertible subordinate debentures had no standing to maintain a derivative action as no fiduciary duty existed and that the rights of the debenture holders were confined to the terms of the indenture agreement, in absence of fraud, insolvency, or violation of statute).

240. 716 F. Supp. 1504 (S.D.N.Y. 1989).

241. *Id.* at 1506.

242. *Id.* at 1508.

243. *Id.* at 1522. The court eventually found Delaware law to be persuasive. Quoting from a Delaware Supreme Court decision, the court stated that:

a corporate bond 'represents a contractual entitlement to the repayment of a debt and does not represent an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties.' Before such a fiduciary duty arises 'an existing property right or equitable interest supporting such a duty must exist.' A bondholder, the court concluded, 'acquires no equitable interest, and remains a creditor of the corporation whose interests are protected by the contractual terms of the indenture.'

*Id.* at 1524 (quoting *Simons v. Cogan*, 549 A.2d 300, 303 (Del. 1988)).

244. *Id.* at 1508 (The court declined to "create an indenture term that, while bargained for in other contexts, was not bargained for here and was not even within the mutual contemplation of the parties").



Also, the Supreme Court of Delaware in *Simons v. Cogan*,<sup>245</sup> refused to recognize a fiduciary duty to holders of convertible debentures, even though the convertible debenture may be converted into equity.<sup>246</sup> In that case, the court stated that "[a] convertible debenture represents a contractual entitlement to the payment of a debt and does not represent an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties."<sup>247</sup>

In contrast, the court in *In re Worlds of Wonder Securities Litigation*,<sup>248</sup> recognized a fiduciary duty between insiders and convertible debenture holders. In that case, convertible debenture holders were granted standing to bring an insider trading action based on the defendants' sales of Worlds of Wonder ("WOW") stock shortly before WOW filed for bankruptcy.<sup>249</sup> The debenture purchasers claimed that they were induced to purchase debentures at artificially inflated prices because WOW allegedly suppressed material, adverse information.<sup>250</sup> The court held that convertible debenture holders have a "relationship of trust and confidence" with corporate insiders.<sup>251</sup> Citing *Pittsburgh Terminal Corp. v. Baltimore & O.R. Co.*,<sup>252</sup> the court further held that debenture and stock purchasers have the same functional relationship to the corporation:

Both invest capital into the corporation, and both contribute to its ability to attract equity. Both rely on the corporation to keep them apprised of its affairs, and both are justified in presuming that corporate insiders are not abusing their position by profiting from undisclosed corporate information. By analogy, then, WOW insiders have a 'fiduciary duty' to debenture purchasers, and the Defendants as tippees can be liable to the Debenture Subclass for trading on the basis of a tip that violated the tippees' fiduciary duty.<sup>253</sup>

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245. 549 A.2d 300 (Del. 1988).

246. *Id.* at 304.

247. *Id.* at 303.

248. [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,689, at 98,235 (N.D. Cal. Oct. 19, 1990).

249. *Id.* at 98,236.

250. *Id.* at 98,237.

251. *Id.* at 98,239.

252. 680 F.2d 933, 941 (3d Cir. 1982) (permitting convertible debenture holders to sue the corporation for nondisclosure of dividend under Rule 10b-5 because "directors must act as fiduciaries to all equity participants," including holders of securities containing stock options), *cert. denied*, 459 U.S. 1056 (1982). "Debenture purchasers as well as stock purchasers have the 'fiduciary' relationship to corporate insiders and their tippees that the Supreme Court has required in *Chiarella* and *Dirks* for standing under Rule 10b-5." *Worlds of Wonder Sec. Litig.*, at 98,239 n.6.

253. *Id.*; see also *Bianco v. Texas Instruments, Inc.*, 627 F. Supp. 154, 163-164 (N.D. Ill. 1985)

Therefore, under the traditional rule alone, members of creditors' committees who are found to be temporary insiders, still could be free to trade in the debt securities of the financially distressed corporation, with the possible exception of convertible debentures, without violating the federal securities laws.

## 2. *Pepper v. Litton*<sup>254</sup>

However, in *Pepper v. Litton*,<sup>255</sup> the Supreme Court recognized an exception to the traditional rule and found that a fiduciary duty does exist between insiders and debtholders of the corporation when the corporation is insolvent — the *raison d'être* of the creditors' committee.<sup>256</sup> In *Pepper*, an insider of an insolvent corporation satisfied a wage claim of his own separate one-man corporation over the claims of other creditors.<sup>257</sup> The Supreme Court denied the insider's claim.<sup>258</sup> Justice Douglas indicated that the traditional relationship between corporate insiders and creditors changes when the corporation becomes insolvent,<sup>259</sup> thus creating a duty.<sup>260</sup> He stated that in the context of an insolvent corporation, the insider's "fiduciary obligation is designed for the protection of the entire community of in-

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(holding option traders had standing to sue corporate insiders who traded options while in possession of material, nonpublic information, because the duty to disclose or abstain from trading is owed "not only to the shareholders of the corporate employer but also to the investing public at large"). *But see Laventhall v. General Dynamics Corp.*, 704 F.2d 407, 411-12 (8th Cir. 1983) (finding that the relationship between the corporation and the option holder did not constitute a relationship of trust and confidence), *cert. denied*, 464 U.S. 846 (1983). "Plaintiff is not trading with the insider or the insider's company. He has bought no interest in it. He is a member of the investing public but he is not investing in the defendant's company." *Id.* at 413.

254. 308 U.S. 295 (1939).

255. *Id.*

256. *Id.* at 307.

257. *Id.* at 299.

258. *Id.* at 313.

259. The shift of fiduciary obligations takes place when the corporation is "at or near insolvency." Note, *Insider Trading in Junk Bonds*, 105 HARV. L. REV. 1720, 1732; see *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 Del. Ch. WL 277613 \*34 (stating that the directors' duty changes when a corporation operates in the "vicinity of insolvency.")

260. *Pepper*, 308 U.S. at 310-11. See Pitt & Groskaufmanis, *supra* note 68 at 231 (relating the formation of the duty to the "trust fund doctrine"); see also *Automatic Canteen Co. of America*, 358 F.2d 587, 590 (2d Cir. 1966) (holding that directors of the debtor's insolvent subsidiary corporation were trustees of the corporate assets for the benefit of the creditors). The court reasoned that directors of an insolvent corporation "occupy a fiduciary position towards the creditors, just as they do toward the corporation when it is solvent." *Id.*; see Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1524 (1993) (stating that "upon insolvency the directors become 'trustees' for the creditors and hold corporate assets as a 'trust fund' for the creditors.").

terests in the corporation — creditors as well as stockholders.”<sup>261</sup>

Although temporary insiders owe duties to shareholders, under the ruling in *Pepper* members of official (and possibly unofficial)<sup>262</sup> creditors’ committee members also owe duties to other creditors, including creditors who are not members of the class represented by the committee member. Accordingly, members of official (and possibly unofficial) creditors’ committees determined to be temporary insiders of the debtor breach duties to all creditors when they trade in the debtor corporation’s debt securities while in possession of confidential information.

### 3. *Misappropriation Theory*

Members of creditors’ committees may also be liable under the misappropriation theory for trading in the debt securities of the insolvent corporation. Although as temporary insiders, the members may not owe a duty to the bondholders of the corporation (absent the ruling in *Pepper*), they do owe a general fiduciary duty to the debtor corporation and its shareholders to “preserve the confidentiality of nonpublic information that belongs to and emanates from the corporation.”<sup>263</sup> Accordingly, committee members who trade in the debt securities of the insolvent corporation on the basis of confidential information breach a fiduciary duty owed to the corporation and may violate Rule 10b-5. To establish the member’s liability, the government does not have to prove that members breached any duties to the shareholders of the corporation.<sup>264</sup>

## CONCLUSION

Members of creditors’ committees and creditor steering committees who purchase or sell, or tip others to purchase or sell, securities of insolvent or financially distressed corporations while in possession

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261. *Pepper*, 308 U.S. at 307; see also *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.* 716 F. Supp. 1504, 1524 n.33 (S.D.N.Y. 1989) (“[I]f the Court here were confronted with an insolvent corporation, which is not the case, the company’s officers and directors might become trustees of its assets for the protection of its creditors, among others.”); *Harff v. Kerkorian*, 324 A.2d 215, 222 (Del. Ch. 1974) (stating that insiders might owe duties in addition to those specified in the indenture in the event of “fraud, insolvency or violation of statute.”); *aff’d in part and rev’d on other grounds*, 347 A.2d 133 (Del. 1975).

262. The expanded obligations of insiders imposed by *Pepper* may apply to steering committee members. See *supra* note 259.

263. *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 10 (2d Cir. 1983), *cert. denied*, 465 U.S. 1024 (1984).

264. See *United States v. Newman*, 654 F.2d 12, 17 (2d Cir. 1981).

of material, nonpublic information may violate the federal securities laws pursuant to two theories.

First, committee members may owe fiduciary duties to their constituents, the committee itself and fellow committee members. Committee members who breach these duties by fraudulently misappropriating confidential information violate Rule 10b-5. In the case of official creditors' committees, it is well established that committee members owe a fiduciary duty to those they represent. Since the misappropriation of inside information would tarnish the reputation of the committee and reflect poorly on fellow committee members, committee members may also owe duties to the committee itself and other committee members. Members of creditors' committees who misappropriate material, nonpublic information in breach of duties to their constituents, the committee itself and to other committee members, violate Rule 10b-5 regardless of whether they owe any duties to the shareholders of the traded securities.

Prior to the passage of the Bankruptcy Code, committee members were found to be fiduciaries to their constituent class. By analogy, it can be argued that creditor steering committees act as fiduciaries to their constituent class. Whether steering committee members act for the interests of their constituent class, or simply for their own interests, is best answered on a case-by-case basis.

Second, members of official and unofficial creditors' committees who are determined to owe fiduciary duties to the debtor corporation may be liable for trading on material, nonpublic information either as insiders, under the temporary insider theory, or the misappropriation theory. Committee members may be characterized as "temporary insiders," and as such, are subject to the same insider trading restrictions as "true insiders" such as directors, officers and shareholders. Traditionally, courts have ruled that creditors' committee members owe no duty to the debtor corporation. However, courts have also recognized that a confidential relationship may exist between parties pursuing different interests. Debtors and creditors' committee members enter into such a relationship to facilitate the reorganization of the debtor. To achieve this objective, committee members are given access to confidential information as a consequence of their expansive investigative powers. Further, the debtor expects creditors' committee members to keep the information secret, and the relationship implies such a duty.

Unlike official creditors' committee members, which are specifi-

cally authorized to investigate the financial affairs of the debtor, creditor steering committees have no defined right to receive or review confidential information concerning the financial affairs of the financially troubled company. Nevertheless, members of creditor steering committees, like official creditors' committees, appear to come within the temporary insider definition articulated in *Dirks*.<sup>265</sup> While the transfer alone of confidential information to the creditor steering committee does not establish a relationship of trust and confidence between the distressed entity and the members of the committee, the additional circumstances surrounding the dealings between the parties suggest the existence of a confidential relationship.

Finally, although insiders generally do not owe duties to debtholders of the corporation, official and unofficial committee members characterized as temporary insiders may, nonetheless, be liable for trading in the debt securities of the insolvent corporation. As temporary insiders of the insolvent corporation, members of official (and possibly unofficial) creditors' committees who trade in the corporation's debt securities while in possession of inside information, breach duties to all other creditors pursuant to the holding in *Pepper*. Committee members who misappropriate and trade in the debt securities of the insolvent corporation based on confidential corporate information breach duties owed to the corporation and may also violate Rule 10b-5.

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265. *Dirks v. S.E.C.*, 463 U.S. 646, 665 n.14 (1983) (describing temporary insider).